Essays on Tax Preparer Decision Making: An Examination of Controls, Motivations, and Decision Outcomes

A Thesis

Submitted to the Faculty

of

Drexel University

by

Beth Y. Vermeer

in partial fulfillment of the

requirements for the degree

of

Doctor of Philosophy

May 2013

DEDICATIONS

This work is dedicated to my four beautiful daughters – Vanessa, Jessica, Emma, and Hallie – who inspire me everyday and fill my life with purpose, love, and laughter. I love you more than you can ever imagine.

ACKNOWLEDGMENTS

I am grateful to many people who provided support and advice as I worked toward completion of my dissertation and, more broadly, as I worked through the Ph.D. program. First, I want to thank my husband, Tom, who wasn't afraid to tell me when my early work wasn't quite as good as I thought it was. I am forever grateful for your advice and support, both of which have been invaluable throughout this process. Also, to my children, Vanessa, Jessica, Emma, and Hallie, for your excitement, support, love, smiles, and hugs. I am so proud to be your mother. I hope each of you tenaciously pursues your passions, measuring success by your own happiness and realizing that nothing you want to accomplish is ever out of your reach.

To my dissertation chair, Tony Curatola, I am so grateful for the support, patience, and encouragement throughout the program and, in your words, for "enjoying the ride" with me. I also want to thank my dissertation committee members, Hsihui Chang, Barbara Grein, Bernhard Reichert, and George Tsakumis for their thoughtful comments and support of my work.

I am also extremely lucky to have an extended support system. My mom, Jayme, who is always there to answer my phone calls and who taught me the value of hard work, thank you for all you do. My sister, Tina, who reminds me not to take things too seriously, and my dear friends, Holly, Rose, Angela, and Greta, who were my constant cheerleaders and awarded me the Ph.D. long before it was official. Thank you for always believing in me. And to my "new" friends from the Ph.D. program: Michael Paz, for the countless hours we spent studying statistics that first year and for your unwavering support and assistance. I am so grateful to have gone through the Ph.D. program with you and to count you as my friend and colleague. To Katrina Graham and Jake Miller, my management conspirators, from those early days of math camp through your presence at my final dissertation defense, I am grateful for your support and friendship through this journey. Finally, to my grandparents, King Bear and Grandma Doll, for teaching me the values of humility and persistence, you are forever a part of everything that I do. I thank all of you.

TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

ABSTRACT

Essays on Tax Preparer Decision Making: An Examination of Controls, Motivations, and Decision Outcomes
Beth Y. Vermeer

To complete the requirements of my doctoral degree, I selected the option of writing a three paper essay series in lieu of a traditional dissertation. The abstracts for each essay are presented in succession.

Essay One: "Behavioral Tax Research: A Review and Prospective"

My first essay is the literature review portion of my essay series, which motivated my second and third essays in the series. In this essay, I explore earlier reviews in behavioral, experimental tax research and continue forward to trace the evolution of ideas in the primary streams of research in this area.

Essay Two: "IRS Oversight, Client Risk, and Tax Professionals: Does Increased Control Deter Aggressive Decision Making?"

My second essay examines the impact of the new Internal Revenue Service (IRS) preparer oversight program on the decision making of tax professionals. Drawing on the tenets of deterrence and control theories, I examine decision making under low and high regulatory scrutiny. In summary, I find

evidence, consistent with extant literature on control theory, that tax professionals increase the aggressiveness of their recommendations and report higher advocacy intentions when facing high IRS oversight.

Essay Three: "Tax Professionals and Antecedents to Aggressive Decision Making: An Examination of Client Identification and Economic Importance"

Motivated by the results of my second essay, my third essay examines why tax professionals may be willing to risk exposure to the increased costs of making aggressive recommendations for their clients. Thus, this essay examines the impact of two antecedents to aggressive decision-making, namely the role of the interpersonal relationship with the client (client identification) and the economic importance of the client, on the recommendations of tax professionals. Consistent with the tenets of Social Identity Theory, I find that stronger client identification leads to more aggressive recommendations and suggest that client identification is an important construct for future research in this area. Further, I find that a client's economic importance does not follow the presumed linear positive relationship with more aggressive recommendations. Rather the results suggest a nonlinear relationship between economic importance and aggressive recommendations, demonstrating a complex and multi-faceted response to economic importance.

CHAPTER 1: ESSAY ONE
Behavioral Tax Research: A Review and Prospective

1.1 Abstract

Taxes are an important accounting phenomenon and accounting research has evolved to foster a niche in tax research that rivals other areas of interest, such as audit and managerial issues. In the following review, I recognize earlier reviews in behavioral, experimental tax research and continue forward to trace the evolution of ideas in the primary streams of research in this area. In addition, I work toward building a framework, highlight important relationships in the research, provide a synopsis of the major findings in each study, and identify how these ideas may relate to future scholarly research in the behavioral, experimental tax area.

Specifically, in order to develop a consistent theoretical web for both taxpayer and tax professional decision-making, I believe it is imperative that our focus on theory development shift to recognizing practical and fundamental tax and accounting concepts. To this end, future research could exploit the underpinnings of the tax environment and examine taxpayer and tax professional behavior in relation to recent tax court cases and administrative rulings, tax law changes, and new IRS initiatives. In addition, future research could examine the iterative interactions of taxpayers and tax professionals, potentially drawing on negotiation literature as a beginning step in this process. Although there are significant areas of improvement necessary in the theoretical framework of experimental, behavioral tax research, these shortcomings may offer significant opportunities for future research in the area.

1.2 Introduction

Taxes are an important accounting phenomenon and accounting research has evolved to foster a niche in tax research that rivals other areas of interest, such as audit and managerial issues. Tax research has also matured to allow for the study of the reciprocal interplay between accounting and tax issues, enabling us to examine phenomena inextricably linked in practice.

Largely, tax research has scattered into empirical and behavioral camps, each with a distinctly different focus. While archival, microeconomic-based, empirical research rigorously tests past transactions and provides direct contributions to how taxes affect other financial and business decisions (tradeoffs), the interaction of taxes and asset prices, multi-national and multistate tax research, and other issues (Shackelford and Shevlin 2001); behavioral, experimental research examines taxpayers, their choices, decisions and attitudes, as well as the biases, elements of judgment, and potential advocacy role of tax professionals in each decision context. These two forms of research are inherently divergent, but collectively complementary, since together they develop a more complete picture of the stakeholders, motivations, transactions, and decision contexts that form the basis of tax transactions. For instance, according to Shackelford and Shevlin (2001), the finding in many recent dividend tax and capital gains tax capitalization studies in the archival area produce surprising results that have the potential to overturn longstanding empirical positions, such as shareholder tax irrelevance (Shackelford and Shevlin 2001). This may be an area where a well-designed experiment could lend additional support to understand the mindset of investors and identify what intrinsic tax factors may contribute to capital pricing decisions.

Behavioral tax research also serves to quantify, explain, and predict the decisions, motivations, and actions of stakeholders, such as taxpayers and tax professionals, in the tax planning, compliance, and decision processes. Experimental, behavioral tax research affords researchers the unique opportunity to engage with these stakeholders, in defined contexts, and gain insight into their decision matrices and personal and professional motivations, imparting a further understanding of the factors that are important in various tax settings.

Shackelford and Shevlin (2001) review empirical tax research and comprehensively detail three areas of research in the archival, microeconomic-based stream of research: how taxes affect other financial and business decisions (tradeoffs), the interaction of taxes and asset prices, and multi-national and multistate tax research. As a result, I will not discuss the archival tax literature. Thus, my aim is to survey and provide a comprehensive review of behavioral, experimental tax research; examine the contributions of prior research in this area; and identify areas that may be fruitful for future scholars of behavioral, experimental tax research.

Much of the prior research in the behavioral tax arena was aimed at identifying attributing factors that impact taxpayer compliance and evasion. In addition, prior research has examined the professional judgment and decision-making processes of tax professionals and, more limited, the ensuing relationship between taxpayer and tax professional. A study of the existing literature leads to primal classification into two broad categories: taxpayer behaviors and the role of the tax professional. Once these broad categories are established, we can parse out subcategories and arrive at the following current streams of research within taxpayer behaviors and the role of the tax professional. The taxpayer behaviors category is divided between taxpayer compliance factors and taxpayer evasion factors and then further parsed into subcategories as indicated: (a) Taxpayer Compliance Factors: (i) framing, (ii) income source, and (iii) taxpayer uncertainty and (b) Tax Evasion Factors and Correlates of Ethical, Moral, and Social Attitudes: (i) ethics (moral obligation), (ii) tax complexity and fairness, (iii) framing (context), (iv) social stigmatization, and (v) audit/litigation success predictions. The role of the tax professional is further parsed into the following subcategories: (i) individual psychological factors, (ii) economic risk and reward factors, (iii) task input factors, (iv) cognitive processing factors, and (v) task output factors.[1]

Four previous survey studies have reviewed behavioral, experimental tax research in the areas of (i) taxpayer compliance research (Jackson and Milliron 1986) and (Cuccia 1994), (ii) tax evasion research (Weigel, Hessing and Elffers 1987), and (iii) tax professionals' judgment and decision-making (Roberts 1998). Jackson and Milliron (1986) surveyed existing tax compliance literature prior to the mid-1980's, recognized 14 variables linked in prior research to taxpayer noncompliance, reviewed methodologies utilized in early tax compliance research, and suggested theoretical areas potentially fruitful for conducting future research. Cuccia (1994) continued the discussion of the

---

[1] See Figure 1 for a diagram of these categories.

development of tax compliance research, summarized additional research findings, theoretically identified how future research should proceed, and advocated for a change in how we define the decision making context. Weigel, Hessing, and Elffers (1987) reviewed early tax evasion and noncompliance research, distinguished between identified variables that instigate taxpayer behaviors and those that act as constraints on taxpayer behaviors, and suggested a social psychological model of tax evasion behavior that the authors believe may contribute to future literature in this area. Finally, Roberts (1998) comprehensively reviewed 52 earlier judgment and decision-making research studies, examined 50 factors affecting tax accountants' decision-making processes, and grouped these factors into five related categories. In the following sections, I will discuss these early reviews in greater detail and continue forward to trace the evolution of ideas in the primary streams of behavioral, experimental research. In addition, I will work toward building a framework, highlighting important relationships in the research, providing a synopsis of the major findings in each study, and identifying how these ideas may relate to future scholarly research in the behavioral, experimental tax area.

Since this review recognizes only behavioral, experimental tax research, I have chosen to categorize reviewed studies based on the primary factors manipulated in each study. I have also highlighted the recognized theories, where appropriate. However, I do not independently discuss methodology in this review because the methodologies, overall, are discussed in prior reviews of the literature (see Jackson and Milliron (1986); Weigel, Hessing, and Elffers (1987); Cuccia (1994); and Roberts (1998)) and are relatively uniform due to the consistent scope of behavioral, experimental tax research that I have reviewed.

Section 2 discusses research on taxpayer behaviors, further refined into categories of compliance and evasion, as indicated. Section 3 summarizes research in the taxpayer behaviors category and highlights prospective thoughts on how future research can enrich studies in this area. Section 4 shifts the focus to detail the role of the tax professional, with further delineation into five categories of factors motivating tax professional judgment and decision-making consistent with Roberts (1998), as indicated. Section 5 summarizes research focusing on tax professionals and provides ideas for future research in this area. Section 6 concludes with an overall synthesis of the literature and prospective thoughts on future research opportunities in the behavioral, experimental tax arena.

1.3 Taxpayer Behaviors

Taxpayer Compliance

Individual taxpayer compliance is a voluntary exercise and the revenues from individual income taxes account for about 45% of total annual tax revenues in the United States. In 2006, the Internal Revenue Service (IRS) reported that the difference between what taxpayers should have paid and what they actually paid on a timely basis (the tax gap) totals to $345 billion. The IRS also concluded that the individual income tax is the single largest source of the annual tax gap, accounting for close to two-thirds of the total tax gap. (IRS 2006) As a result, individual income tax compliance is an important issue that behavioral tax research should and has investigated.

The early work in behavioral tax research examined the attributes of taxpayers in tax compliance situations. Jackson and Milliron (1986) surveyed existing tax compliance literature prior to the mid-1980's and provided a host of variables linked in prior research to taxpayer noncompliance. In addition, Jackson and Milliron (1986) reviewed the methodologies utilized in early tax compliance research and suggested theoretical areas for establishing a basis for conducting future research. The authors then proceeded with a call for refining methodological approaches to research, such as using more sophisticated statistical designs and techniques in survey research, increasing realism in experimental research, and relating research to theory. They suggested that deterrence theory and prospect theory may prove most fruitful in tax compliance research. Research articles such as those by White, Harrison, and Harrell (1993), Christensen and Hite (1997), Vines and Wartick (2003), and others answer this call with research including elements of prospect theory and framing effects as well as elements of deterrence theory. Jackson and Milliron (1986) also discuss agency theory as a potential way to study the relationship between taxpayer and tax preparer and as a way to explain or highlight a tax preparer's motivations. A wealth of research has examined the role and decisions of tax preparers, which I will discuss in a subsequent section.

The most important contribution of this early review was the recognition and summarization of 14 variables linked to taxpayer compliance.[2] The authors highlighted the occurrence of these 14 variables in 43 early taxpayer compliance studies across four dimensions: survey studies, experimental studies, analytical studies, and regression modeling. The 14 variables consist of: age, sex, education, income level, income source, occupation, peer influence, ethics, fairness, complexity, IRS contact, probability of detection, sanctions, and tax rates. Some of these variables have persisted and are examined in current compliance related research. In particular, studies examining income source, ethics, fairness, complexity, tax rates, and IRS contact will be specifically reviewed in conjunction with other research studies.

In the following section, I will use Jackson and Milliron's (1986) identification of income source as a variable category, which has received attention from subsequent research. I have also identified and prescribed two additional variables, framing and taxpayer uncertainty, which I will use to highlight subsequent research in these areas. Of the remaining variables identified by Jackson and Milliron (1986), I will discuss ethics (moral obligation), tax complexity and fairness (tax law equity), compliant peers (social stigmatization), probability of detection (audit/litigation success predictions), and several other variables that are examined secondarily as part of the manipulations of subsequent tax evasion research.

---

[2] The authors specifically reference 14 variables in their main tables. They also note several other variables that were examined not included in the tables.

Framing

The framing of a transaction as a win/lose scenario or as a tax due/tax refund may imply different contextual connotations to taxpayers. The basic premise of these studies is that certain contextual factors, such as receiving a refund, will promote greater taxpayer compliance. Several studies have examined the impact of framing effects on how taxpayers process tax information and make tax decisions.

White et al (1993) build upon two prior research studies, marrying prospect theory and deterrence theory, by examining the framing of an individual's income tax withholding position (tax refund versus additional tax due) when filing their annual tax return posited against low, medium, and high detection rates and penalties. White et al (1993) find that experimental subjects in a tax due position are more likely to engage in noncompliant behaviors than those in a tax refund position. When examined against a three-way interaction among withholding position (tax due or refund), detection rate (at three levels), and penalty amount (at three levels), the framing effects were significant in all but the very lowest detection and penalty rates. The study also found that adult taxpayers engaged in more noncompliant behavior than undergraduate students.

In contrast to White et al (1993), Christensen and Hite (1997) examine whether taxpayers' risk perceptions and subsequent reporting decisions are influenced by the type of reporting decision (income or deduction), framing effects (win or lose), and level of uncertainty. The authors found that taxpayers' decisions are influenced by the presence of ambiguity and the level of uncertainty, but found no evidence of a correlation with framing effects.

Vines and Wartick (2003) experimentally examine the implications of offering a direct subsidy versus a tax deduction to a disadvantaged taxpayer. Both direct subsidies and deductions can be used to promote social and economic objectives; however, the form (framing) of the payment may have implications for how the payment is perceived and, subsequently, the individual's reporting of income on a tax return. The authors found that, despite the equivalence of the two subsidies, participants disadvantaged by not receiving a tax deduction reported less income than participants disadvantaged by not receiving a direct subsidy.

Income Source

Drawing from one of the variables identified in Jackson and Milliron (1986), we now turn our attention to the effect of income source on taxpayer compliance behaviors. Income source studies, in particular the effects of earned versus endowed income, have produced surprising results in how taxpayer behaviors may be influenced by the form of the income and the effort required to derive the income.

Boylan and Sprinkle (2001) attempt to reconcile discrepancies between experimental taxpayer compliance studies and archival-empirical studies by examining the impact of endowed versus earned income on the relationship between tax rates and compliance decisions. Most experimental compliance research endows participants with income, resulting in a decrease in tax compliance, whereas, archival-empirical studies use data that typically includes earned income. Specifically, the authors find results consistent with archival-empirical studies and economic theory when manipulating the effect of a tax rate increase (20% to 40%) on a taxpayer's decision to report more (less) taxable income when income is earned (endowed). This highlights the fact that taxpayers may respond differently to the amount of time and effort required to earn income in making compliance related decisions.

Boylan (2010) followed the line of research investigating differences between earned and endowed income with an examination on taxpayer compliance subsequent to a prior audit. Boylan (2010) finds that taxpayer compliance increases following a prior audit in situations involving endowed income, but taxpayer compliance decreases following a prior audit in situations involving earned income. These results induce the conclusion that the impact of a prior audit on a taxpayer's subsequent compliance decisions is affected by the time and effort required to generate the income. This study may also help posit another explanatory variable, source of income, useful for examining the effects of prior audits on taxpayer decisions.

Taxpayer Uncertainty

While taxpayer uncertainty has received some attention in prior research, the following studies attempt to study changes in uncertainty when interacted with other economic factors, such as tax rate, penalty rate, and audit probability and how this uncertainty may impact taxpayer decisions to report taxable income.

Klepper (1988), Alm, Jackson, and McKee (1992), Milliron (1985), and others began examining taxpayer uncertainty and tax complexity in relation to tax reporting decisions. Beck, David, and Jung (1991) continued to develop this research in the experimental economic area utilizing and fine tuning a tax reporting model, which examines changes in uncertainty and other economic factors, such as tax rate, penalty rate, and audit probability, on reported taxable income. In the 1991 study, the authors found that when penalty rates and audit probabilities increased, risk-neutral subjects were found to report higher levels of income. The results also suggested that a reduction in uncertainty led to higher (lower) levels of reported taxable income when penalty rates or audit probabilities were decreased (increased).

Beck, Davis, and Jung (1992) continued this research stream by examining nonstrategic and strategic audit regimes and found that tax rate changes have significant effects on tax reporting decisions under both audit regimes. However, an increase in taxable income uncertainty contributed to a decrease in subjects' reporting low income under strategic audit scenarios, but had no effect on income reporting in a nonstrategic audit regime. Overall, subjects reported low income more frequently than was predicted using either model.

Beck, Davis, and Jung (1996) extended the study of Beck et al. (1992) using a game-theory model and found that taxpayer uncertainty and prescribed audit policies increased risk and, thereby, increased the prevalence of the decision to purchase professional tax advice. The taxpayers in the experiment also tended to purchase tax advice more frequently than predicted in the model, even though taxpayers then tended to ignore the purchased advice when making reporting decisions. Finally, the authors conclude that the availability of tax advice does not have an effect on post-audit tax revenues.

The study by Beck et al. (1996) begins to examine the interaction effects of a tax professional on the taxpayers' decision-making process, which I believe is imperative in the examination of taxpayer compliance, avoidance, and evasion decision contexts. The authors contribute an interesting idea to the literature; however, the requisite assumptions of the models employed may introduce severe limitations to the realism and generalizability of the results. Furthermore, I suggest that the interactions between taxpayer and tax professional may implicitly be an iterative give and take process not tested in these experiments.

Summary and Suggestions for Future Research

As noted above, research subsequent to the review by Jackson and Milliron (1986) has continued to examine piecemeal factors of taxpayer compliance.[3] I have highlighted studies involving the examination of framing effects, income source, and taxpayer uncertainty and their subsequent impact on taxpayer compliance decisions. Although many of the aforementioned studies motivated their particular manipulations within the theory suggested by Jackson and Milliron (1986), the authors found dissimilar results in some cases and, ultimately, do not move us any further toward a comprehensive framework of taxpayer compliance behavior called for in the early review by Jackson and Milliron (1986). Specifically, while subsequent studies have used theories to motivate specific variables, they have not worked toward developing a theory that provides a comprehensive understanding of taxpayer behavior.

[3] See Table 1 for a summary of behavioral tax compliance research.

This lack of a unifying theory is again highlighted in Cuccia's 1994 literature review. Cuccia (1994) discusses the development of tax compliance research, summarizes previous research findings, theoretically identifies how future research should proceed, and advocates for a change in how we define the decision making context. Cuccia (1994) suggests that economic models of taxpayer compliance may not be constructed to serve as good predictors of behavior since there are a myriad of differences in taxpayer attitudes and biases. However, the author believes that economic incentives are important for understanding taxpayer behavior and perhaps we should integrate economic and noneconomic factors. Cuccia (1994) posits that a better approach, which examines small groups of taxpayers with homogenous incentives, both economic and attitudinal, may propel us toward a better understanding of tax compliance. Cuccia (1994) cautions, however, that the two areas in which economic-based research may prove most beneficial is in examining professional preparers and corporate compliance and not necessarily individual compliance.

While the primary streams of behavioral tax research have seemingly shifted away from individual taxpayer compliance, this area will continue to gain attention due to the pervasiveness of compliance related issues. With increased initiatives on the part of the IRS to close the Tax Gap (U.S. Treasury 2009) and increase taxpayer compliance, there has never been a better time to provide an enhanced understanding of the taxpayer compliance environment. As a whole, behavioral, experimental tax research has not presented a cohesive model or found an encompassing underlying theory of individual tax compliance behavior. I do not believe it would be fair to define this as a failure, but rather an admittance that tax compliance behaviors are as varied and somewhat unpredictable as each of the individuals that comprise the taxpayer community. It is difficult to define all the overlapping factors, motivations, and underlying assumptions that go into a tax compliance decision and; therefore, tax research will continue to persist in discovering and refining the best predictors of tax compliance behavior that can be found at any particular time for that particular subset of individuals.

While manipulations of individual taxpayer behavior may uncover a novel variable or construct, I believe that a conclusive model of taxpayer behavior which explains taxpayer compliance as a homogenous phenomena may not be a viable possibility, given the current lack of definition and continuity in the theoretical framework currently in place. I do believe a model grounded in practical theory might help us illuminate taxpayer behaviors in response to actual, practice based tax decisions and may move us toward a more cohesive model of taxpayer behavior. Also, theories, like the Theory of Planned Behavior, can support our experimental manipulations and provide proverbial coat hangers upon which we can hang our interrelated web of findings supported by each respective theory of taxpayer behavior. However, our focus on theory development should shift to recognizing practical and fundamental tax and accounting concepts. We should seek to adopt a more practice driven vantage point, similar to that found in capital markets research, financial accounting research, and auditing research. From a practical vantage point, we could exploit the practical underpinnings of the tax environment and examine taxpayer behaviors in relation to new tax laws, new IRS initiatives, and in response to changes in the accounting and tax environment. For instance, in the last few months, over 10,000 tax professionals received letters from the IRS, notifying them that the IRS would potentially be visiting their offices to "heighten awareness of preparer responsibilities and increased IRS oversight of tax return preparers". (IRS 2010$_a$) The preparers selected to receive the letters come from a pool of preparers who historically submit a large number of returns with Schedules A, C or E, regardless of professional designation. How do we begin to examine the impact of this increased oversight? How does it impact and motivate taxpayers who have substantial Schedule A, C, or E income? How can we ground these questions and motivate them with theoretical underpinnings stemming from legal tax rulings and findings from IRS inquiries?

By shifting our focus to developing a practically motivated theory and model of taxpayer compliance, we might find the theoretical cohesion we are seeking to define and assemble the collective body of work in behavioral, experimental tax research. Further, our findings would evolve to enhance our collective understanding of the tax compliance environment and allow us to contribute to the practical and legal implications facing taxpayers, tax practice, and regulatory bodies.

Tax Evasion and Correlates of Ethical, Moral, and Social Attitudes

While tax compliance seems straight forward, the lack of compliance (noncompliance) could be a result of perceived or defined tax avoidance or tax evasion. As such, these terms represent dissimilar constructs in practical definitional terms.

However, prior studies surveyed in tax research have intertwined the terms so much that the lines of delineation between one concept and another are cumulatively blurred. As such, I will continue my discussion with an eye toward tax evasion, understanding that many of the reviewed compliance studies actually may be examining tax evasion behaviors in the operationalization of their compliance manipulations. For example, Boylan (2010) finds that taxpayer compliance increases following a prior audit in situations involving endowed income, but taxpayer compliance decreases following a prior audit in situations involving earned income. This may be an overall test of tax evasion and how the income is ultimately reported to the taxpayer and the IRS or the specific source of the income that demonstrated higher compliance results in this study is perceived as targeted by IRS initiatives, as experience with a prior audit would now reveal. Since the lack of definitional categorization cannot be fixed at this time, the remainder of this section will be buffered with a specific emphasis toward examining the ethical, moral, and social attitudes present in tax evasion decisions.

Weigel, Hessing, and Elffers (1987) review early tax evasion and noncompliance research, distinguish between identified variables that instigate taxpayer behaviors and those that act as constraints on taxpayer behaviors, and suggest a social psychological model of tax evasion behavior that the authors believe may contribute to future literature in this area. The authors identify financial strain (amount of taxes due after withholding) and personality (orientation, dissatisfaction, equity, fairness, and direct experience with enforcement authorities) as variables supporting tax evasion behaviors and opportunity (occupation and income source), threats of punishment (probability of detection and sanctions), social disapproval, and personal controls (moral and civic beliefs, ethics, and attitudes about evasion) as constraints motivating individuals away from evasion behaviors.

While Weigel et al. (1987) review the specific construct of tax evasion, their evasion variables significantly overlap those of Jackson and Milliron (1986). See Table 2 for a correlation of the compliance variables identified in the Jackson and Milliron (1986) review and the Weigel et al. (1987) review.

In deference to continuity and due to the high correlation between the compliance and evasion variables, I use the variables identified by Jackson and Milliron (1986) to categorize tax evasion studies, in the following section, with the following variable definitions[4]: ethics (moral obligation), tax complexity and fairness (tax law equity), and compliant peers (social stigmatization). I have also identified and prescribed two additional variables, framing and audit/litigation success predictions, which I will also use to highlight subsequent research in the area of tax evasion. Many of the tax evasion studies also manipulate several other variables introduced by Jackson and Milliron (1986) that are examined secondarily as part of the manipulations of subsequent tax evasion research.

[4] Jackson and Milliron (1986) identified 14 variables. I use the stated variable in my categorizations and place the equivalent term used in current research in parentheses next to each of Jackson and Milliron's (1986) defined variables.

Ethics (Moral Obligation)

Ethics and moral obligation are important constructs for examining the evasion decisions of taxpayers. This area of research is particularly rich in psychological theories, such as deterrence theory, the theory of reasoned action, and the Theory of Planned Behavior, which examines attitudes, subjective norms, and perceived behavioral control.

Reckers, Sanders, and Roark (1994) interject on the findings of White et al (1993) and other related studies that examine withholding effects (refund or tax due positions) and tax rate effects in taxpayer evasion decisions. Reckers et al (1994) find that tax ethics may be highly significant in tax evasion decisions and posit that tax ethics (morals) may be a missing variable in tax modeling scenarios.

With the precept that moral obligation may proceed as a moderating influence in tax compliance decisions (Reckers et al. 1994), Bobek and Hatfield (2003) incorporate the Theory of Planned Behavior and use it as a theoretical framework for examining taxpayer compliance intentions. Based on Reckers et al. (1994), they add moral obligation to the theory's specific constructs of attitude, subjective norms, and perceived behavioral control. The authors find that the role of moral obligation is influential, but much more complex than Reckers et al. (1994) suggested. In particular, high levels of moral obligation alone do not eliminate cheating, but high levels of moral obligation interacting with other factors in the decision scenario may contribute to higher tax compliance.

Ghosh and Crain (1995) find that individuals with lower ethical standards will display more intentional noncompliance. However, a person's attitude toward risk may overcome the influence of ethics in more uncertain audit environments. Ghosh and Crain (1995) examine moral obligation and the resulting effects when ethics are interacted with variables of risk and uncertainty.

Hanno and Violette (1996) examine beliefs and norms underlying taxpayer compliance decisions using the theory of reasoned action, a social psychological model. Using the model, the authors find that both self-reported and hypothetical compliance behaviors were related to a taxpayers' intention to comply. The authors found specific differences in compliance intentions and behaviors when traced to differences in beliefs about the following interacting variables: moral and civic obligations, concerns about monetary outcomes of compliance decisions, and social pressures of an IRS audit.

Kaplan, Newberry, and Reckers (1997) extend prior research on moral reasoning by examining the effect of moral reasoning and educational communications on tax evasion intensions. Specifically, the authors conducted an experiment in which they gave subjects a Defining Issues Test, which measures the level of moral reasoning in a person's decision-making skills. Then, the authors proceeded to gather information about each subjects' reporting decisions in decisions where the opportunity to evade was high. The authors concluded that tax evasion intensions were significantly lower for taxpayers who demonstrated high moral reasoning.

Tax Complexity and Fairness (Tax Complexity and Tax Law Equity)

In prior research, tax fairness has involved at least two dimensions: overall perceived benefits derived for tax paid and the equity of a taxpayer's burden in relation to other taxpayers. Tax complexity research studies the perceived complexity of the tax system. Prior research on tax complexity has found mixed results and, it appears, that the impact of tax complexity may be highly correlated with other compliance factors, such as fairness and opportunity for evasion. Tax fairness research has also found similar results, with a highly correlated linked to tax complexity. This is perhaps the motivation for the following study, which examines ways to moderate and understand the perceptions of complexity and overall fairness of the tax laws.

Carnes and Cuccia (1996) examine the effects of taxpayer perceptions of tax law equity and complexity on taxpayer compliance. The authors find that taxpayers have consistent beliefs about the necessity of tax complexity and these beliefs are found to moderate the predicted belief that tax complexity generates a negative perception of equity. The authors conclude that taxpayers need to understand the justifications for tax complexity and taxing authorities should consider simplifying areas of the tax law that are perceived as least justified and/or educate taxpayers as to the purposes for complexity.

Framing (Context)

Framing was introduced as a new variable under taxpayer behaviors, suggesting that the context of the decision may be as important as the actual compliance/evasion decision at hand. The following study specifically examines how the absence of the tax context may have severe consequences to the external validity of the results.

Wartick, Madeo, and Vines (1999) highlight the issue of context in tax experiments. Specifically, they explain that the experimental economics method, increasingly employed to study the impact of tax policy on taxpayer behavior, attempts to create a microeconomy in the laboratory with strict controls that effectively eliminate any connotations to real-world phenomena. This association to the real-world could cause decisions based on external values rather the rewards and penalties established in the microeconomy. The authors find that introduction of the tax context subsequently caused subjects to report more income than when nontax context was introduced. Age also played an important factor in how much income was reported in each decision context. These findings cause questions about experimental economics methods that did not strictly control the impact of context in the experiment. Again, this study raises the issue of whether we can effectively remove tax context in taxpayer compliance and evasion decisions and retain external validity in our research.

Compliant Peers (Social Stigmatization)

Research in this area has examined the effects of a taxpayers' associates, including friends, relatives, co-workers, and other peer groups. Utilizing deterrence theory, reference theory, and the correlation with the probability of detection, prior research has found a significant positively correlated link between the influence of peer groups and tax evasion.

Porcano and Price (1993) continue this line of research with an examination of the effects of social stigmatization on tax evasion decisions. The authors study several variables employed to determine their influence on the stigmatization effect. The authors find that social stigmatization, overall, was an effective penalty that significantly affected tax evasion, especially when larger amounts of cash were involved, audit probability was higher, and the number of noncompliant peers was lower.

Audit/Litigation Success Predictions

Predictions of audit/litigation success are closely tied to the probability of detection, which has been examined in prior literature. Prior findings have found mixed results in their examination of detection probability as a factor in tax evasion decisions. This is an interesting area that should receive additional consideration, especially given the IRS growing concern over the Tax Gap and recent efforts to bring more taxpayers to compliance. The following study illustrates how the prediction of audit and subsequent litigation success may contribute to the propensity to evade taxes, an unintentional consequence of taxpayer protection efforts surrounding the burden of proof rules.

Magro and Stetson (2004) examine the impact of the burden of proof rules under Internal Revenue Code, Section 7491. The burden of proof rules effectively shift the burden of proof, in certain tax cases, to the Internal Revenue Service rather than to the taxpayer. Magro and Stetson (2004) found that, as a result of this shift in burden of proof, taxpayers exhibited an increased expectation of success in litigation and an increased likelihood that they would engage in more unsound tax-motivated transactions.

Summary

Ethics (moral obligation), tax complexity, tax law equity, framing of the decision context, social stigmatization, and audit/litigation success predictions are all variables examined in the tax evasion literature that have shown to correlate with taxpayer evasion behaviors and decisions.[5]

Weigel et al. (1987) and Porcano (1987) present and discuss variables effecting taxpayer evasion decisions. As mentioned above, comparing the variables in these two reviews of tax evasion research with variables identified in the taxpayer compliance literature, I find that the attributes related to taxpayer compliance and the attributes related to tax evasion are highly consistent. At the outset, this signifies an immediate opportunity for further refinement of how we define and examine the distinct constructs of compliance and evasion and the resulting variables that may be specifically and/or uniquely applicable to each.

Other Taxpayer Studies

Although most behavioral, experimental tax research has examined taxpayer compliance and evasion correlates, Boylan and Frischmann (2006) examined the role of

[5] See Table 3 for a summary of tax evasion research.

tax complexity in investment decisions. In their examination, the authors manipulated the complexity for participants to derive their marginal tax rates. The authors found that tax complexity leads to systematically and inefficiently high trading prices and quantities, which limited the amount of overall wealth created and systematic transfers of wealth between the subjects and the tax authorities increased.

This is a particularly interesting topic that future research should explore in greater depth. Practically, there have been a number of changes in the tax rates and tax rules relating to investment income in recent years. Have these tax changes contributed to greater understanding among investors of their investment tax implications or have they led to greater complexity and greater inefficiencies? How do taxpayers respond to changes in investment tax rates? Do certain taxpayers perceive the tax rate cuts on investment income and subsequent capital gains as unfair or inequitable? Do tax rate differences on investment income elicit a socially positive or negative response among taxpayers? Do tax rate reductions on investment income encourage more or less tax evasion behaviors among different classes of taxpayers? The answers to these questions may help us influence future tax policy and may lead to greater understanding of the reasons for the increasing Tax Gap.

1.4 Synthesis and Prospective – Taxpayer Behaviors

Taxpayer compliance may be defined as a taxpayer's intentions, actions, and reporting decisions to comply with tax laws, while the lack of compliance (noncompliance) could point to either tax avoidance (the legal reduction in taxes by utilizing the tax laws to a taxpayer's advantage) or tax evasion (illegally not paying taxes). Future research in the taxpayer compliance area should thoughtfully employ delineation between the constructs of tax compliance, tax avoidance, and tax evasion to avoid confusing the concepts. While an appreciation for testing in "gray areas" might find interesting results, tax evasion is a particularly curious practical construct that intrinsically carries potentially substantial risks of penalty, such as possible prison terms, etc., and should be tested as such.

Experimental economic research focuses on creating a laboratory environment in which "real world" phenomena are not introduced to the subjects' cognition. I argue that by removing the pervasive and unique definitional construct of tax evasion, we may be destroying external validity in our findings.

An overall appreciation for how taxpayers interpret their decisions would be interesting. For instance, do taxpayers understand what activities constitute tax avoidance versus evasion? Do they understand the consequences of evasion? Does the magnitude (materiality) of the decision change how taxpayers define tax evasion and, consequently, effect their decisions?

Further, examining taxpayers individually does not account for the role of the tax professional in most complicated and material tax decisions. The role of the tax professional and the relationship between taxpayer and tax professional are paramount to our understanding of overall tax reporting and planning issue. As such, we now turn our attention to the following factor in the tax decision schema: the role of the tax professional.

1.5 Role of the Tax Professional

Tax professionals may serve to mitigate or reinforce taxpayer decisions and, as such, stand as the gatekeepers of tax issues and how they may be reported or resolved. A major area of tax noncompliance and potential evasion, as referenced by the tax gap indicators, is in the reporting of itemized deductions, self-employment income, and other forms of business income. The IRS has increased focus on this area by promising to scrutinize Schedules A, C, and E and further indicted the role of the tax professional in this arena with an increased focus on regulating and sanctioning the tax professional. (IRS 2010_a)

Roberts (1998) comprehensively reviews earlier judgment and decision-making research as it applies to tax accountants. The author explains 52 studies, identifying and examining 50 potential factors affecting the tax accountants' decision-making processes. Roberts (1998) categorizes these 50 factors into five related groups:

(1) Individual psychology factors, including experience, knowledge, and problem-solving ability (cognitive factors) and advocacy, confirmation bias, ethical attitude, and risk preference (affective factors);

(2) Economic risks and rewards associated with the tax accountant's three constituency groups: external regulatory bodies, the client (client preference), and the firm;

(3) Factors describing the decision-making task, such as ambiguity or complexity of the tax laws;

(4) Factors describing decision-process features, such as the order in which information is examined, framing, and effects of pressure, accountability, and decision aids on information processing; and

(5) Factors of specific task outputs: tax compliance (facts are closed and cannot be changed) versus tax planning (facts are open and can be changed to include more favorable tax treatment)

For consistency, I will generally continue with these categories, highlighting and discussing subsequent literature within each category identified above. In subsequent studies of tax professionals, many of the factors identified above are studied across one or more of the five factor categorizations. In these cases, I attribute the study to the factor category of the primary manipulation and then discuss the other potential factors involved.

Individual Psychological Factors

Advocacy and Confirmation Bias

Prior research in this area has examined tax professionals' attitudes about advocacy and their own risk propensity and how these factors affect recommendations, increase or decrease effort in search behavior, and exhibit confirmation bias in the evaluation of facts and circumstances of the decision-making context. Several subsequent studies are discussed below, which examined advocacy attitudes and the resulting impact on tax professional planning and decision processes. I will start our discussion with an introduction to the widely accepted Mason and Levy (2001) general advocacy scale.

Mason and Levy (2001) examined the difference in advocacy attitudes between 34 CPA's and 30 IRS agents. The results of their study led to the development of a nine-item advocacy scale that measures intrinsic client advocacy. Several studies have used the Mason and Levy (2001) scale, including Kadous and Magro (2001), Davis and Mason (2003), Barrick, Cloyd, and Spilker (2004), Kahle and White (2004), and Bobek, Hageman, and Hatfield (2010). Stephenson (2007) and Pinsker, Pennington, and Schafer (2009) also utilize the Mason and Levy (2001) scale with exclusion of one or more items in the measurement scale.

Hatfield (2001) examined how the perceived objectivity of the staff accountant and the manager's inherent client advocacy affect the manager's use of the staff accountant's research report in the forming client recommendations. The objectivity assessment and use of the staff accountant's research report is influenced by whether the research report confirms or disconfirms the manager's initial opinion (advocacy).

Barrick, Cloyd, and Spilker (2004) examined the influence of biased tax research memoranda on supervisors' judgments made during the review process. The authors posit that tax professionals orient toward recommendations that meet the joint objectives of accuracy and advocacy. Barrick et al. (2004) found that supervisors are more persuaded by an unbiased memorandum (more accurate) when the client-preferred position (advocacy) cannot be achieved. Further, when neither memorandum meets the accuracy objective, supervisors are more persuaded by the memoranda in which the advocacy objective might be met.

Stephenson (2007) examined advocacy levels between CPAs and non-CPAs, as measured using the Mason and Levy (2001) scale. The authors found that advocacy levels are fairly equal between CPAs and non-CPAs and that clients of each were found to have similar perceptions of the aggressiveness of their preparers. Namely, tax preparers exhibited higher advocacy levels than the advocacy level perceived by their clients.

Pinsker, Pennington, and Schafer (2009) investigated how training in the role of tax professional versus the role of auditor influence advocacy attitudes and how the context of the decision environment interacts with advocacy attitudes to influence judgment and decision making. The results of this study indicate that the context of the specific decision environment does serve as a moderating effect on advocacy attitudes. Specifically, the authors found that judgments of accounting professionals in a tax decision environment tie more close to their advocacy attitudes than judgments in audit decision environments. The authors also found that tax professionals are more likely to adapt to the professional requirements of advocacy or skepticism than are their audit counterparts.

Another study indicating the impact of training and attitudes is Cloyd and Spilker (2000). In this study, the authors examined whether academic training may influence the extent to which tax researchers are subject to confirmation bias. Cloyd and Spilker

(2000) found that law students were less prone to bias in resolving ambiguous tax research issues than were Master of Accounting students.

Bobek, Hageman, and Hatfield (2010) examined whether client specific characteristics influence the level of advocacy tax professionals' exhibit and how client-specific advocacy affects tax professionals' judgments and decisions. The authors examined the impact of practice risk on tax professionals' decisions and extend existing research by examining the impact of client importance on client advocacy and directly measuring general client advocacy and client specific advocacy using the Mason and Levy (2001) advocacy scale. Bobek et al. (2010) also determined whether advocacy impacts the judgment decisions of tax professionals. Bobek et al. (2010) found that practice risk impacts client advocacy, recommendations, and allowance of favorable tax advice while client importance only impacts the allowance of favorable tax advice and not client advocacy or subsequent recommendations.

Knowledge

In prior research, a tax professionals' level of knowledge has consistently been significant in explaining differences in judgment and decision-making performance. Several prior studies found that task-specific knowledge was a better indicator of improved judgment and decision-making than were years of experience or any other experience indicator. (Roberts 1998). The article below addresses institutional knowledge as a feature influencing tax research and planning contexts.

Magro (2005) examined the impact of relevance institutional knowledge on responses to features of tax-planning and compliance contexts. Specifically, tax professionals with relevant institutional knowledge conducted broader and more extensive information searches in planning contexts than compliance contexts, leading to increased tax research performance. Conversely, tax professionals lacking relevant institutional knowledge did not exhibit this information search adaptivity and exhibited lower tax research performance.

Economic Risk and Reward Factors

Client Preference

Prior research has examined client preference as an inducement for a tax practitioner to exhibit increased confirmation bias behavior. This confirmation bias can be strong enough to result in inaccurate assessments of the underlying authoritative support for a client-favored position as well as lead tax professionals to make overly aggressive recommendations (Cloyd and Spilker 1999). The authors found that subjects' information searches emphasized cases with conclusions consistent with the client's desired outcome (positive cases) over cases inconsistent with the client's desired outcome (negative cases), despite the fact that the positive cases were no more similar to the client's facts.

Kahle and White (2004) attempt to examine two decision biases that the authors believe exist in the tax professionals' weighting of evidence in a decision task: tax professionals' initial beliefs, which the authors define as advocacy, and bias induced by client preference. The authors find that tax professionals are not confirmation prone, but are highly susceptible to biases toward client preference. Kahle and White (2004) also find that belief revisions are greater when it supports client preferences, as indicated by the tax professionals' advocacy role. Cumulatively, subjects weighted evidence with potentially positive tax consequences more heavily than evidence with potentially negative consequences. However, contrary to findings related with other decision makers, subject discounted evidence that was consistent with their own a priori beliefs.

Practice Risk

Prior research in the client preference and advocacy areas has indicated that tax professionals' decision-making abilities may be clouded by these constructs and may not objectively evaluate tax authorities and evidence relevant to their research and decision contexts. Failure to objectively evaluate the proper tax authority in a decision context leads to practice risk exposure. Practice risk is defined as "exposure to monetary and nonmonetary costs of making inappropriate recommendations" (Kadous and Magro 2001). Since it appears that no specific categorization of this construct is defined in Roberts (1998), I have created a newly defined subcategory entitled practice risk and will discuss subsequent literature in this area.

Kadous and Magro (2001) manipulate practice risk to demonstrate how practice risk affects how tax professionals process information in their recommendation-formation process. Specifically, the authors find that tax professionals weight information differently for high-risk clients (weaker recommendation for aggressive tax position) than for low-risk (stronger recommendation for aggressive tax position) clients, despite identical underlying transactions. These findings indicate that tax professionals consider their own risk of monetary and nonmonetary sanctions ahead of their professional responsibilities as client advocates.

Kadous, Magro, and Spilker (2008) examined whether high practice risk mitigates the effects of client preferences (confirmation bias towards client preferences) in tax professionals' information search and subsequent judgments. The authors find that tax professionals' searches, when facing a client with low practice risk, are biased in a manner leading to judgments consistent with client preferences; however, when facing a client with high practice risk, the search is less biased toward client preferences. Kadous et al., (2008) also found that, after controlling for the impact of client search, tax professionals ultimately adjusted their recommendations away from client preferences, regardless of the level of designated practice risk.

Penalties

The effect of penalties in prior research has produced mixed results. Some tax professionals exhibit less aggressive decision-making when the chances for penalties and sanctions are higher (increased economic and noneconomic costs), but some tax professionals display psychological rewards from "playing the game" and beating the IRS. (Roberts 1998)

Anderson and Cuccia (2000) examine the economic incentive effects of tax return preparer penalties. Contrary to earlier studies, the authors find that an increase in tax return preparer penalties provides incentives for practitioners to identify fewer tax-reducing opportunities, reduce the aggressiveness of their reporting recommendations, and increase their fees. The authors also find that these economic incentives may be moderated by the presence of environmental competition and moral hazard.

Task Input Factors

Precedent/Amount of Legal Authority

Tax input factors, such as ambiguity, complexity of tax law, amounts of legal authority, etc., have been examined in prior literature and have been found to effect the judgment and decision-making abilities of tax professionals. The study described below contributes to task input literature by examining the effect of precedent on a tax professionals' judgment.

Davis and Mason (2003) formulate and test a psychological feature-matching model that describes how tax professionals evaluate precedent from prior court decisions and administrative rulings. The authors then used this model to predict how tax authority judgments would be influenced by taxpayer advocacy, the relative amount of detail known about the client fact situation, precedent, and asymmetry. Davis and Mason (2003) found that factors such as taxpayer advocacy, the relative amount of details known about the client fact situation, and precedent influence tax professionals' judgment regarding the similarity of precedent to the client fact situation. Specifically, the outcome of the court case had a stronger influence on the likelihood of success judgment as similarity of the client fact situation and precedent increased, but the results were only sensitive to the common features and not the distinctive features of the client fact situation or precedent. In addition, the authors find that taxpayer advocacy may influence similarity judgments and authority when studied with the joint influence of the outcome of the court case presented in the study.

Cognitive Processing Factors

Source Credibility

Framing and information order have been examined in prior research studies. Source credibility examines the impact of the origin of the information and the relative weight the tax professional places on the information contained in the source. The following study contributes to literature examining cognitive processing factors on tax professionals' decision-making processes.

Alexander (2003) examined how strategy memorandum from local staff versus the National Tax Office (NTO) and the type of engagement (client-initiated versus firm-initiated) affected both the extent of the tax professionals' subsequent review of the proposed tax-saving strategy and the difference in the tax professionals' assessed likelihood of litigation success before and after conducting the review. Specifically, the author found that the most extensive reviews were conducted when the engagement was firm-initiated and the memorandum came from the NTO and the least extensive reviews were found when the engagement was firm-initiated with a local office memorandum or when the engagement was client-initiated with a NTO memorandum. The smallest change in assessed likelihood of success in litigation was in the condition where review was most extensive and the memorandum was issued by the NTO; whereas, the largest change in assessed likelihood was in the condition where the review was relatively limited and the memorandum was prepared by local office staff.

Task Output Factors

Planning versus Compliance Decision Contexts

Prior research has generally found that tax preparers exploit ambiguity in tax rules to help clients reach favorable reporting positions in tax compliance situations. Spilker, Worsham, and Prawitt (1999) extend this research by examining whether tax professionals differ in their aggressiveness stance between tax compliance and tax planning contexts. The authors confirm previous findings that tax professionals interpret ambiguity more aggressively to the benefit of the taxpayer in tax compliance situations, but relatively conservatively in tax planning situations.

Another study examines the identification of significant differing features between the tax compliance and tax planning contexts. In general, tax planning involves greater complexity, ambiguity, and justifiability demands than do compliance issues. Magro (1999) examined this identification of features and found that experienced tax professionals rated tax planning cases higher in complexity, ambiguity, and justifiability demands than tax compliance cases. In addition, tax managers budgeted more time in tax planning contexts.

1.6 Synthesis and Prospective – The Role of the Tax Professional

Similar to taxpayer compliance and evasion studies, research of tax professionals has also examined piecemeal factors and has failed to offer a unifying theory that provides a comprehensive theory of tax professional behavior.[6] However, these studies seem to have somewhat stronger theoretical foundations for their particular manipulations than their counterpart studies of taxpayers. Although this is a minor improvement, my overall suggestions for the future of taxpayer compliance and evasion studies also hold for experimental, behavioral research of tax professionals.

Tax professionals consist of a varied group of individuals, including CPA firms of varying sizes, enrolled agents, and non-certified preparers. Given that behavioral research has examined the quality of CPA firm firms by size, future research of tax professionals should examine whether differences exists among the diverse groups of preparers and what factors may mitigate these differences.

[6] See Table 4 for a summary of tax professional research.

1.7 Synthesis and Prospective – Behavioral Tax Research

The aim of this study is to survey and provide a comprehensive review of behavioral, experimental tax research; examine the contributions of prior research in this area; and identify areas that may be fruitful for future scholars of behavioral, experimental tax research. Given that individual income taxes account for about 45% of total tax revenues in the United States, individual income tax is the single largest source of the annual tax gap, and the recognition that there is limited archival data for individual taxpayers and tax preparers, experimental, behavioral tax research affords researchers the unique opportunity to understand the decisions, motivations, and actions of stakeholders, such as taxpayers and tax professionals, in the tax planning, compliance, and decision processes.

Overall, this review hints at the concept that behavioral, experimental tax research, for both taxpayers and tax professionals, is progressing without a cohesive theoretical and practical supporting web. As noted in my summaries of taxpayer behaviors and the role of the tax professional, there have been four literature reviews that have called for a comprehensive framework of behavioral tax research and no study to date has answered these calls. Rather than providing this framework, research subsequent to these reviews has examined piecemeal factors of taxpayer compliance and the judgment and decision making decisions of tax professionals. To develop theories for both taxpayer and tax professional decision-making, I believe it is imperative that our focus on theory development shift to recognizing practical and fundamental tax and accounting concepts. For example, when Watts and Zimmerman (1978) developed Positive Accounting Theory in the for-profit arena and Zimmerman (1977) developed a theory for municipal accounting, these approaches helped the development of a theoretical framework that was grounded/supported by practice. To this end, future research could exploit the underpinnings of the tax environment and examine taxpayer and tax professional behavior in relation to recent tax court cases and administrative rulings, tax law changes, and new IRS initiatives.

Given that most sophisticated taxpayers hire tax professionals and the impact of tax professionals on taxpayer avoidance and evasion has recently become a key focus of the IRS, future research should examine the interactions of taxpayers and tax professionals together. We should recognize that, from a practical perspective, this interaction involves an iterative give and take process. Future experimental, behavioral tax research should consider drawing on the negotiation literature to examine the give and take process between taxpayer and tax professional.

Although there are significant areas of improvement necessary in experimental, behavioral tax research, these shortcomings may offer significant opportunities for future research in the area. Looking forward, the primary aim of this study is to provide a framework to extend this important area of research.

CHAPTER 2: ESSAY TWO
IRS Oversight, Client Risk, and Tax Professionals: Does Increased Control Deter Aggressive Decision Making?

2.1 Abstract

The Internal Revenue Service has recently increased its monitoring of tax professionals by implementing a new direct oversight program, which includes visits to tax preparer offices for the first time in 2010. Although deterrence theory suggests that these recent provisions will increase compliance, extant literature on control theory suggests that increasing controls often has the unintended effect of causing an increase in the aggressive behaviors the controls aim to constrain. Using an experiment with tax professionals at a national tax conference, I find evidence that tax professionals increase the aggressiveness of their recommendations and report higher advocacy intentions when presented with high direct IRS oversight, although this desire appears to be tempered by the client's perceived risk tolerance. Additionally, the results suggest that practice risk impacts the final recommendations of tax professionals, but may only be an effective deterrent against aggressive decision making for high risk taxpayers, which only accounts for a small portion of the taxpayer population. The results should be useful for regulators as they consider the optimal type and level of tax preparer oversight and the expanded levels of practice risk should be beneficial to future research in this area.

2.2 Introduction

As tax laws have become more complex and the majority of taxpayers now rely on the services of tax professionals, the Internal Revenue Service (IRS) has increased its focus on tax preparer regulation.[1] In 2009, the IRS modified their regulatory efforts by announcing an unprecedented and systematic plan to begin direct monitoring and oversight of paid preparers (IRS 2010a). While prior IRS efforts focused solely on increasing preparer penalties and passing more rigorous standards of conduct, these new measures have completely altered the landscape of regulatory enforcement with the IRS visiting tax preparer offices and reviewing client files for the first time in 2010 (JOA 2011). The IRS notes that these regulatory efforts are aimed at enforcing taxpayer compliance through tax preparers and ensuring uniform and high ethical standards of conduct for tax preparers (IRS 2009a, 2010d).

Although the IRS has increased its focus on tax preparer regulation, prior research, to my knowledge, has not examined the impact of the direct monitoring and oversight of tax preparers. Additionally, earlier studies examining the effects of audit probability and penalties provide conflicting evidence on the impact of tax preparer regulation.[2] Thus, the purpose of this paper is to examine the effects of these unprecedented direct oversight initiatives on (1) tax preparer recommendations and (2)

---

[1] According to IRS Publication 4822, the percentage of returns filed by a paid preparer was 59.33% in 2009. (IRS 2011a)

[2] Earlier studies include Anderson and Cuccia (2000); Cloyd and Spilker (1999); Cuccia (1994a); Newberry, Reckers, and Wyndelts (1993); Reckers, Sanders, and Wyndelts (1991); Kaplan, Reckers, West, and Boyd (1988).

client advocacy intentions and (3) to determine whether these effects vary with client risk characteristics. Using an experiment with 151 tax professionals at a national tax conference, I manipulate two important variables in a tax professional's decision-making environment (regulatory environment/oversight and client characteristics).[3] Consistent with IRS provisions, I manipulate oversight at two levels [high (tax preparer has received a letter from the IRS and has been officially selected for a visit from the IRS) and low (tax preparer has not received a letter from the IRS and will not be visited)]. Also, given the importance of client characteristics in a tax professional's decision-making process (Milliron 1988), I define and manipulate practice risk at three levels (low/moderate/high) by varying client characteristics such as completeness of records, client responsiveness, and incidence of prior audit. In addition to providing evidence regarding the effects of direct IRS oversight on tax preparer recommendations, I build upon prior research on advocacy (Bobek, Hageman, and Hatfield 2010; Mason and Levy 2001) by examining the impact of direct IRS oversight on a tax preparer's client advocacy intentions. Finally, I extend prior research on practice risk (Kadous, Magro, and Spilker 2008; Kadous and Magro 2001) by examining and parsing out the effects of specific client characteristics on a tax professional's final recommendations and advocacy intentions.

The IRS has historically behaved in a manner consistent with deterrence theory, which suggests that increasing (1) the severity of punishment, (2) the probability of punishment, and (3) the certainty of detection will increase tax compliance (Butterfield

---

[3] Interviews with tax professionals at Big Four, regional, and local CPA firms suggest that the primary considerations in a tax professional's decision-making process are the regulatory environment and client characteristics.

2002; Newberry et al. 1993; Witte and Woodbury 1985). Initially, the IRS focused on increasing the severity and probability of punishment by working to tighten penalties, sanctions, and standards of care over tax professionals (IRC Section 6694). Recently, the IRS has focused on increasing the certainty of detection through direct oversight of tax preparers, which engages the third prong of deterrence theory. This direct oversight should be especially effective given that scholars examining deterrence theory have found that the certainty of detection is significantly more important than the severity of punishment (Eide 1994; Decker and Kohfeld 1990; Witte 1983).

While increasing the certainty of detection should lead to a decrease in aggressive behavior according to the tenets of deterrence theory, the inherent advocacy role of tax professionals and their intermediary role between the IRS and taxpayers may cause unexpected reactions to increased IRS control. According to extant literature on control theory, increasing controls often has the unintended effect of causing an increase in the aggressive behaviors the controls aim to constrain because they are perceived as a sign of distrust destroying goodwill between the parties (Christ 2008; Falk and Kosfeld 2006). Therefore, extant literature on control theory and results from earlier tax studies, finding a positive or no significant relationship between increased regulatory risk (Cloyd and Spilker 1999) or increased threat of economic sanction (Cuccia 1994a) and aggressive tax reporting, suggest that tax preparers may act more aggressively in the presence of direct oversight by the IRS. Hence, this study attempts to reconcile the divergence between the IRS' intended application of deterrence theory and the implicit control relationship that tax professionals may perceive and respond to.

The results provide evidence that the current IRS oversight program may not work as intended on the professional tax community. In fact, consistent with extant literature on control theory, as IRS direct oversight increases, tax professionals increase their levels of aggressiveness in tax decision making and recommendations. These results are consistent with a tax practitioner's desire to challenge the IRS (Roberts 1998; Cuccia 1994b) or a building-up of negotiating position with the IRS (Slemrod 2007). Further, the results suggest that tax professionals increase their reported advocacy levels when presented with high direct IRS oversight which is consistent with a tax preparer's increased willingness to fight for client positions when faced with higher IRS scrutiny.

Kadous and Magro (2001) introduce a relative concept of practice risk, defined by varying client characteristics that may alter a tax professional's decision-making. Prior research on practice risk finds that tax professionals adjust their final recommendations away from the client preferred position for both low and high risk profiles, suggesting that practice risk may not impact a tax professional's final recommendations[4] (Kadous et al. 2008). In this study, I extend research on practice risk by further parsing out specific client attributes that alter the final recommendations of tax professionals. I operationalize practice risk at three levels (low/moderate/high). The results build on the importance of practice risk, suggesting that practice risk does impact tax professionals' final recommendations. Specifically, at low IRS oversight levels, there is a significant difference in recommendations between low and moderate practice risk clients and between moderate and high practice risk clients, with tax professionals

[4] The authors find that practice risk impacts information search, but, contrary to their hypothesized predictions, the authors find that practice risk does not alter final recommendations.

becoming significantly less aggressive moving from low to moderate to high practice risk. However, the results suggest that practice risk may only be an effective deterrent against aggressive decision-making when tax professionals encounter the high practice risk level, which accounts for only six percent of the taxpayer population.[5]

The results also suggest an interaction effect between IRS oversight and practice risk. Specifically, when faced with high IRS oversight, tax professionals become significantly more aggressive in their final recommendations for moderate and high practice risk taxpayers; however, high IRS oversight has no significant impact on a tax professional's recommendations for low practice risk clients. The results suggest that a tax professional's desire to be more aggressive, as a reaction to increased control, may be tempered by the perceived risk tolerance of the client. Future research should examine the specific client attributes causing this perception of higher risk tolerance.

This study makes several contributions to the literature. First, to my knowledge, this is the first study to examine whether the direct monitoring of tax preparers under the tenets of deterrence theory is useful in increasing tax compliance. Given the inherent conflict between the roles of advocate for the client and enforcer for the IRS, the findings suggest that the current IRS oversight program may not be appropriate for controlling the general tax preparer population. These findings should be especially useful for regulators

---

[5] As a validation measure for each manipulation of practice risk (low/moderate/high) in this study, each participant was asked to estimate the percentage of their current tax clients that are similar to the given client profile. Each tax professional received and responded to only one client profile. Cumulatively, 144 tax professionals estimated the percent of similar clients to the low/moderate/high practice risk profiles as 64.20 percent/31.33 percent/6.04 percent on a 100 percent scale.

as they consider the optimal type and level of tax preparer oversight, especially given that the IRS has consistently behaved in a manner consistent with deterrence theory.

Second, I demonstrate that high IRS oversight leads to higher advocacy intentions and that advocacy intentions remain high for the majority of a tax professional's client base. These results provide evidence of an increased "us versus them" mentality and support a tax professional's motivation to make more aggressive recommendations in the presence of high IRS oversight. On the whole, the results indicate a strong adherence to the professional standard of advocacy, which may make tax professional attitudes impermeable to the IRS' attempts to utilize them as implicit agents of taxpayer enforcement.

Finally, the results on practice risk should be useful to future researchers as this concept continues to evolve. I provide evidence of the impact of specific client characteristics, such as incidence of prior IRS audit and a history of significant litigation, on a tax professional's final recommendations. The results enable researchers to understand which components may be important to manipulate in future studies and should compel additional research on whether practice risk impacts other factors such as tax fees and client retention.

The remainder of this paper proceeds as follows. Section II provides institutional background regarding IRS regulation, Section III develops theory and hypotheses, Section IV describes the research method, Section V presents the results, and Section VI concludes the paper.

2.3 Institutional Background

In 2007, Internal Revenue Code (IRC) Section 6694 was amended to increase both the severity and probability of punishment of tax professionals for understatements due to unreasonable positions. These revisions included widening the scope of penalty enforcement, increasing penalty amounts, and modifying the standard of conduct from a "realistic possibility" to a "more likely than not" standard.[6] Although these changes represented a significant increase in the severity and probability of punishment, in 2009, Douglas Shulman, Commissioner of the IRS, announced an unprecedented and systematic plan to begin the direct monitoring and oversight of paid tax preparers. The Commissioner noted that these provisions will "help the IRS better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers" (IRS 2009a, 2010a).

In January 2010, the IRS issued over 10,000 letters to tax professionals across the country who prepare a large volume of tax returns where errors are commonly seen[7]. These letters notified tax preparers of their responsibilities to file accurate returns, outlined the consequences of filing incorrect returns, and notified the preparers of a potential IRS field visit. (IRS 2010c) Later in 2010, the IRS conducted approximately

---

[6] First-tier penalties (for unreasonable positions) were increased from $250 to the greater of $1000 or 50 percent of the income derived by the tax return preparer. Second-tier penalties (for willful or reckless conduct) were increased from $1000 to the greater of $5000 or 50 percent of the income derived by the tax return preparer. The "realistic possibility standard" required a one-in-three likelihood that the reported tax position would be sustained on its merits, while the increased "more likely than not standard" requires a better than 50 percent chance that the reported tax position will be sustained on its merits.
[7] Tax returns with Schedules A, C, or E.

5,000 field visits of these tax return preparers. During these visits at preparer offices, the IRS inquired regarding the firm's general procedures for handling taxpayer data and reviewing the accuracy of each return, quizzed the tax preparer on IRC Section 6694, and reviewed a random sample of tax returns and supporting documents (JOA 2011). In 2010, these visits led to 56 indictments, 25 convictions, and 21 civil injunctions. (IRS 2010c). Building on their efforts in 2010, the IRS sent out an additional 10,000 letters for 2011, with plans to visit more than 2,500 additional preparers during the year. (IRS 2011b) Beginning their third year of implementation in November 2011, the IRS increased the scope of their oversight initiatives, sending letters to approximately 21,000 tax preparers with plans for numerous oversight field visits during 2012 (IRS 2011c).[8,9]

2.4 Theory and Hypothesis Development

IRS Oversight

Prior research examining IRS regulatory activities toward tax professionals has reported conflicting results. Certain earlier studies examining the effects of audit probability and penalties on tax preparer judgment and decision-making find that higher audit probabilities and increased penalties have a significant impact on reducing the

[8] The results of the 2011 and 2012 visits (second and third year of the oversight initiatives) have not been published.

[9] CAMICO, the largest CPA-directed program of liability insurance for accounting professionals in the U.S., suggests that policyholders selected for an IRS office visit should contact CAMICO's loss prevention department immediately to determine what would be appropriate to produce to the IRS during a compliance visit, as well as how to appropriately address the requests for production of confidential client information.

aggressiveness of tax professionals' recommendations.[10] Conversely, several studies find that manipulating the probability of IRS audit (Cloyd and Spilker 1999) or increasing the threat of economic sanctions (Cuccia 1994a) has no significant effect on tax professional decision-making and recommendations[11]. Further, Cuccia (1994b) and Roberts (1998) argue that, in the adversarial setting of tax practice, increasing penalties can create a competitive game with the IRS, with intrinsic psychological rewards for playing the game and beating the IRS. Slemrod (2007) also suggests that tax professionals may consider an aggressive tax position to be an "opening bid", understanding that any ultimate resolution may be a lengthy process of negotiation.

Extant literature on tax preparer decision-making presumes that the IRS acts in accordance with deterrence theory (Butterfield 2002; Newberry et al. 1993; Witte and Woodbury 1985). Deterrence theory (Becker 1968) suggests that increasing (1) the severity of punishment, (2) the probability of punishment, and (3) the certainty of detection should deter an individual from making aggressive tax reporting decisions and, hence, increase tax compliance. Amendments to IRC Section 6694 in 2007, which widened the scope of penalty enforcement, significantly increased penalty amounts, and modified the standard of conduct for tax professionals, engaged two prongs of deterrence theory by significantly increasing both the severity and probability of punishment. Subsequently, in 2009, the IRS oversight plan engaged the third prong of deterrence theory by increasing the certainty of detection through the direct monitoring and

---

[10] These studies include McGill 1990; Reckers et al. 1991; Newberry et al. 1993; Roberts and Cargile 1994; Kaplan et al. 1988; and Anderson and Cuccia 2000.

[11] Cuccia (1994a) finds that increased penalty threats resulted in CPAs recommending significantly more aggressive positions, although the results were not statistically significant.

oversight of tax preparers (IRS 2010a). These newly implemented oversight initiatives should provide for the greatest enforcement effectiveness, given prior research on deterrence theory, which finds that increasing the certainty of detection may be the most important factor in deterring unwanted behaviors (Eide 1994; Decker and Kohfeld 1990; Witte 1983).

While the tenets of deterrence theory suggest that increasing the certainty of detection should provide for a decrease in aggressive behaviors, tax preparers may perceive the implicit increase in IRS control as a sign of distrust or an intrusion to their professional environment and may react negatively. Control theory, stemming from sociology, suggests that absent societal or institutional bonds, people act opportunistically to get what they desire. Therefore, centralized (bureaucratic) control is necessary and must be maintained through administrative measures, such as setting additional standards or policies. Extant literature on control theory, however, finds that increasing controls to force compliance may be perceived as a signal of distrust by the controlled party, which often leads to harmful and dysfunctional effects (Christ 2008; Falk and Kosfeld 2006; Christ, Sedatole, and Towry 2006). Further, Christ et al. (2006) and Christ, Sedatole, Towry, and Thomas (2008)[12] find that, as the perception of scrutiny increases and/or the controls become more intrusive, trust is eroded, increasing the risk of noncooperation. As a result, the IRS' imposition of direct monitoring and oversight of tax preparers may increase the perception of both increased scrutiny and increased intrusiveness. Both of these perceptions have the potential to negatively impact trust and cooperation, leading to

[12] These control studies examine and discuss the effects of controls on management, employees, business partners, business associates, and on collaborative relationships, such as alliances between organizations.

the potential for tax preparers to increase aggressive behaviors as a reaction to increased IRS control. These aggressive behaviors may be especially acute given the inherent advocacy role of tax professionals and their intermediary role between the IRS and taxpayers. Figure 1 illustrates the inherent advocacy role of tax professionals and the potentially counterproductive relationship between deterrence pressure from the IRS and control reactions from tax professionals.

[Insert Figure 1]

Hence, according to the basic tenets of deterrence theory, increasing the detection rates of aggressive tax reporting decisions should *decrease* aggressive decision-making; however, extant literature on control theory suggests that increasing controls over the tax preparer population may cause unexpected and potentially contradictory reactions to control, leading to an *increase* in aggressive decision making as control increases. Therefore, two competing arguments have the potential to explain how these new IRS oversight initiatives may impact a tax professional's decision making, leading to the following competing hypotheses:

> H1a (deterrence theory): As IRS oversight increases, tax professionals will make less aggressive (client favorable) recommendations.
>
> H1b (control theory): As IRS oversight increases, tax professionals will make more aggressive (client favorable) recommendations.

Advocacy

Hypothesis one examines the impact of IRS oversight on tax professionals' recommendations. Although the final recommendation is a critical decision, Bobek et al. (2010) note the construct of advocacy plays a critical part in tax judgment and decision making research given that a primary role of tax professionals is to advocate for their client. Advocacy can also serve as a signal of the underlying motivation in forming the final recommendation. Given the importance of this construct, I examine the impact of IRS oversight on advocacy measures, which have been significantly linked to professional recommendations and judgment processes in prior literature (Bobek et al. 2010; Kahle and White 2004; Davis and Mason 2003; Mason and Levy 2001).

Client advocacy, as defined by prior tax literature, "is a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer" (Mason and Levy 2001). Advocacy is unique to the tax profession in that tax preparers have both the "right and responsibility to be an advocate for the taxpayer" when recommending a tax return position. (AICPA 2009)

Extant literature has examined the effects of advocacy directly (Kahle and White 2004; Davis and Mason 2003; Mason and Levy 2001) or inferred it as support for biases in judgment (Cloyd and Spilker 1999). Bobek et al. (2010) extend this line of research finding evidence that client advocacy influences preparer decision-making and, furthermore, that advocacy is at least partially client and context specific.[13] While Bobek et al. (2010) find support that client characteristics, as an endogenous factor, impact advocacy measures and decision-making, Schafer (2010) suggests that future research should examine external influences, beyond client characteristics, that may impact a tax preparer's client advocacy.

Hence, I examine whether IRS oversight (as an external influence) impacts client advocacy intentions and, as such, serves as an underlying motivation for the recommendation decisions measured in hypothesis one. Specifically, according to the tenets of deterrence theory, increased risk exposure resulting from imminent (high) IRS oversight should decrease a tax professional's advocacy intentions, especially given that increasing the certainty of detection has been found to be the most important factor in deterring unwanted behavior. However, in accord with extant literature on control theory, IRS oversight could also increase advocacy intentions, with tax professionals demonstrating an increased intention to "fight for" their client's position or an increased "us versus them" mentality, leading to the following competing hypotheses:

> H2a (deterrence theory): As IRS oversight increases, tax professionals will report lower client advocacy intentions.
>
> H2b (control theory): As IRS oversight increases, tax professionals will report higher client advocacy intentions.

[13] Bobek et al. (2010) introduce the concept of client-specific advocacy. I extend this concept of client-specific advocacy, measuring advocacy intentions, specific to each client, across each oversight and practice risk manipulation.

Practice Risk

Prior research (Kadous and Magro 2001; Kadous et al. 2008) suggests that practice risk is significantly impacted by client characteristics. Specifically, clients that are uncooperative, frequently involved in litigation, and have incomplete records are high practice risk clients that expose tax professionals to greater monetary and nonmonetary costs for making inappropriate recommendations. Given that tax professionals should recognize and respond to these risks, higher levels of practice risk should motivate tax professionals to engage in a more comprehensive and balanced decision process, resulting in less biased decision-making.

Prior studies have defined practice risk at two levels (low and high), finding that high practice risk mitigates recommendations of an IRS challenge (Kadous and Magro 2001) and mitigates confirmation bias (Kadous et al. 2008). However, Kadous et al. (2008) find, contrary to their hypothesized expectations, that tax professionals adjust their recommendations away from client preference, irrespective of practice risk.[14] In order to build upon Kadous et al. (2008) and expand research on practice risk, I operationalize practice risk at three levels, creating new characterizations of low and moderate practice risk profiles while replicating Kadous et al.'s (2008) definition of high practice risk as an anchor to prior research.[15] [16]

---

[14] The authors find that practice risk impacts information search, but, contrary to their hypothesized predictions, the authors find that practice risk does not alter final recommendations.

[15] As a validation measure for each manipulation of practice risk (low/moderate/high) in this study, each participant was asked to assess the perceived risk level of the client profile and the percentage of their current tax clients that are similar to the given client profile. Each tax professional received and responded to only one client profile. Cumulatively, 144 tax professionals rated the perceived risk level of the low/moderate/high practice risk taxpayer profiles as 1.93/4.94/5.82 on a scale ranging from lowest (1) to

This study operationalizes low practice risk without any incidence of prior audit. IRS data reveal that 143 million individual income tax returns were filed with the IRS in 2007 while 1,384,563 individual returns were audited in 2007, representing a less than one percent (.009682) chance of audit for an individual taxpayer in 2007 (IRS 2009b, 2010b). Given this evidence, tax practitioners may identify a taxpayer who has been previously audited by the IRS as a higher risk taxpayer. As a result, I define low practice risk with the following statement: "They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation."

Additionally, I define moderate practice risk by eliminating any history of engaging their tax practitioner and others in litigation. While litigation would increase practice risk, interviews with tax professionals at Big Four, regional, and local CPA firms suggest that this scenario may be viewed as unacceptable given that tax professionals are rarely sued by tax clients. Further, I believe it is worthwhile to determine the impact of an IRS audit without confounding it with the presence of significant litigation. Therefore, I define moderate practice risk with the following statement: "They have a history of responding slowly or failing to respond to requests for information or documentation, usually provide incomplete records when requested, have been unable to

---

highest (7) risk. Cumulatively, 144 tax professionals also noted the percent of similar clients of the low/moderate/high practice risk profiles as 64.20 percent/31.33 percent/6.04 percent on a 100 percent scale.

[16] See Table 1 for the full definitions of practice risk used in prior studies.

defend tax positions during prior IRS audit, and have no history of engaging their tax practitioner or others in litigation."

Finally, as an anchor to prior research, I replicate the definition of high practice risk used in Kadous et al. (2008) with the following statement: "They have a history of responding slowly or failing to respond to requests for information or documentation, have been unable to defend tax positions during prior IRS audits, and have a history of engaging their prior tax practitioner and others in litigation." In sum, I capture varying sensitivity to practice risk at three levels, leading to the following hypothesis:

> H3a: As practice risk increases, tax professionals will be less likely to make aggressive (client favorable) recommendations.

Further, Bobek et al. (2010) examine practice risk at two levels (low and high) and find that tax professionals exhibit lower levels of client-specific advocacy for high practice risk clients. Since this study expands the definition of practice risk to three levels (low/moderate/high), I build upon prior research in this area by extending sensitivity to practice risk and examining the impact on advocacy measures at each level of practice risk, leading to the following hypothesis:

> H3b: Client-specific advocacy intentions will decrease as practice risk increases.

2.5 Research Methodology

I examine the hypotheses using an experiment in which tax professionals were asked to make recommendations on two client fact scenarios (ambiguous and non-ambiguous)[17]. Both IRS oversight risk (2 levels) and practice risk (3 levels) were manipulated between participants within the experimental materials.

Participants

The participants are practicing tax professionals recruited at a national tax conference.[18] This method of recruitment provides for a large sample of experienced tax professionals who regularly deal with and make decisions on individual taxpayer issues and who are unlikely to be biased by geographic location or any singular firm size, training, or practice philosophy. I recruited 153 participants out of 281 in attendance at the conference. Two (2) tax professionals were excluded from the experiment because they had been through an IRS oversight audit, leaving 151 out of 281 (54% response rate) tax professionals who completed the experiment. Of those, 7 failed manipulation checks or had incomplete data, resulting in 144 usable participant instruments.

Of the 144 participants, the experience level ranged from 2 to 22 years, with a mean experience level of 4.36 years; 49.3 percent possessed a master's degree or MBA; 46.5 percent held a bachelor's degree; and 71.5 percent held a current CPA license.

---

[17] The non-ambiguous scenario is used as a baseline control measure to validate the robustness of the results and to rule out the potential for alternative explanations. See the discussion of the baseline control measure in the additional analysis section of the paper.

[18] Approval was granted for the use of human subjects in this experiment by the institution where this experiment was conducted.

Participants were primarily employed by national accounting firms (22.2 percent), regional accounting firms (45.8 percent), and local accounting firms (29.2 percent) and held the title of staff or experienced staff (33.3 percent), senior (51.4 percent), and manager or senior manager (11.8 percent).[19] [20]

Experimental Design

The experiment employs a 2 x 3 full factorial design, manipulating two levels of oversight risk (low and high) and three levels of practice risk (low/moderate/high). In addition to the between subjects manipulations of oversight risk and practice risk, I asked each participant to respond to both an ambiguous and a non-ambiguous decision.[21]

In this study, the imminent (high) oversight condition is manipulated with a statement that the tax preparer and/or their firm received a letter from the IRS that they might be visited and, subsequently, were notified that they had been officially selected for a visit from the IRS during 2011. Conversely, the general (low) oversight condition is manipulated with a statement that the tax preparer and/or their firm have not received a letter from the IRS in either 2010 or 2011 and will not be visited during 2011. The three manipulations of practice risk (low/moderate/high) were described in detail in the Theory and Hypothesis Development Section and are summarized in Table 1.

[Insert Table 1]

---

[19] I also conducted a pilot study with 84 graduating accounting majors at a leading four-year university and 12 practicing tax professionals with similar results. The results of the pilot study provided timely feedback and helped to refine the instrument and determine proper procedures for conducting the experiment with tax professionals.

[20] The results do not differ significantly when I control for experience, age, gender, or any of the demographic measurements.

[21] All participants received both the non-ambiguous and ambiguous scenarios. I alternated the order of presentation to control for order effects and order does not influence the results.

Experimental Procedures

I provided participants with a research instrument containing two parts (Part A and Part B). In Part A, participants were first provided with a brief introduction to the new IRS oversight initiatives, then given a statement with the manipulated oversight level (high/low) that would apply to both parts of the experiment. Next, the participants were provided with a short client vignette, including the manipulated level of practice risk (low/moderate/high), followed by a summary of pertinent facts about the taxpayers' issue[22] and appropriate IRS regulations for reference to support their decisions. Participants were asked to read the significant facts of the case, review the appropriate tax authority related to the tax scenario, and make a recommendation on hobby versus business treatment for the tax issue. Then, participants were asked to answer questions about the riskiness of the decision, the riskiness and similarity of the client profile, and other issues related to their decision. Participants then completed the Mason and Levy (2001) advocacy scale specific to their client scenario.[23] Upon completion of all of the above (Part A), participants turned in Part A and then completed Part B[24]. Part B contained the second client vignette and participants were reminded of their IRS oversight level (high/low), asked to read the significant facts of the case, review the appropriate tax authority, and make a recommendation. Then, participants were asked to answer questions about the riskiness of the decision, the riskiness and similarity of the

---

22 See Appendix A for the ambiguous and non-ambiguous client fact scenarios.

23 Consistent with the concept of client-specific advocacy introduced by Bobek et al. (2010), the Mason and Levy (2001) advocacy scale was administered by replacing the general term "taxpayer" with the hypothetical client names for each item on the scale.

24 Part A and Part B were later matched using nondescript codes on the front page of each part.

client profile, and other issues related to their decision. Participants then completed the Mason and Levy (2001) advocacy scale specific to their second client scenario. At the end of Part B, participants were asked to answer demographic questions, including years of experience as a tax professional, type of firm, title, CPA/non-CPA, gender, type of degree, and age.

2.6 Results

The hypotheses are tested using a 2 x 3 ANOVA (IRS oversight risk by practice risk) with recommendation as the primary dependent variable for H1a, H1b, and H3a and advocacy as the primary dependent variable for H2a, H2b, and H3b.

Ambiguous Decision Making – IRS Oversight

H1a predicts that, as IRS oversight increases, tax professionals will make less aggressive (client favorable) recommendations in accord with the expectations of deterrence theory. Conversely, H1b predicts that, as IRS oversight increases, tax professionals will make more aggressive (client favorable) recommendations as they respond to increased IRS control. Tax preparers reported their recommendation on a ten-point, forced-decision scale, with 1 indicating "Definitely Hobby" and 10 indicating "Definitely Business". Mean recommendations by experimental condition are presented in Table 2, Panel A and support H1b, indicating a significant positive relationship between increased IRS oversight and increases in aggressive decision making (overall mean of 6.04 when IRS oversight is high and overall mean of 5.21 when IRS oversight is low). The ANOVA results for the model are presented in Table 2, Panel B and are significant at conventional levels ($F = 13.79$, $p < 0.001$). Overall, these results suggest that tax professionals are likely to make a more aggressive reporting recommendation when IRS oversight is high, suggesting a negative response to increased controls by the IRS. Additional analysis presented in Table 2, Panel C suggests that tax professionals are more aggressive when IRS oversight is high for both moderate and high practice risk clients, but insignificant when practice risk is low. These results are further analyzed in the additional analysis section, which examines the effects of the interaction of IRS oversight and client practice risk.

[Insert Table 2]

The results for the current IRS oversight program, in this experimental setting, are contradictory to the tenets of deterrence theory upon which the IRS relies, but consistent with expectations from studies on control theory and prior tax research, which indicate a desire to challenge the IRS (Roberts 1998; Cuccia 1994b) or a building-up of a negotiating position with the IRS (Slemrod 2007). This implies that increased IRS oversight may be counterproductive to attempts to deter aggressive behavior because, as tax professionals respond to increased scrutiny and more intrusive controls by the IRS, trust and cooperation between the parties may be negatively affected.

Advocacy – IRS Oversight

[Insert Table 3]

H2a posits that, as IRS oversight increases, tax professionals will report lower client advocacy intentions, while H2b posits that, as IRS oversight increases, tax professionals will report higher client advocacy intentions, demonstrating an increased "us versus them" mentality in response to increased IRS control. Using the Mason and Levy (2001) advocacy scale, each participant responded to nine questions using a seven point Likert-type scale on each question, ranging from strongly disagree to strongly agree. The results, presented in Table 3, support H2b, indicating that tax professionals increase their reported advocacy levels when presented with high IRS oversight (mean = 43.60) versus low IRS oversight (mean = 39.79, $F = 7.80$, $p = 0.006$). This finding supports the notion that advocacy is affected by external factors beyond client characteristics. Further, the results demonstrate a positive relationship between increases in advocacy measures and increases in aggressive decision-making, supporting prior findings that advocacy intentions directly relate to the decision-making processes. Overall, the results on advocacy support and provide motivation for the results of hypothesis one, wherein tax professionals respond unfavorably to increased IRS control and make more aggressive recommendations in the presence of high IRS oversight.

Ambiguous Decision Making – Practice Risk

H3a predicts that, as practice risk increases, tax professionals will be less likely to recommend the client-preferred tax position. Using a ten-point, forced-decision scale, tax professionals reported their recommendations at each of three manipulated levels of practice risk (low/moderate/high). The ANOVA results for practice risk are presented in Table 2, Panel B and are significant at conventional levels ($F = 29.80$, $p < 0.001$). Mean recommendations by experimental condition are presented in Table 2, Panel A and indicate that tax professionals decrease the aggressiveness of their recommendations as practice risk increases. For example, at the low IRS oversight level, tax professionals recommend business treatment (mean = 7.21) for a low practice taxpayer, but decrease their recommendation when faced with the moderate practice risk taxpayer (mean = 5.42) and recommend hobby treatment for the high practice risk taxpayer (mean = 2.91).

Kadous et al. (2008) find that practice risk impacts information search; however, contrary to hypothesized expectations, the authors find that practice risk does not alter final recommendations.[25] Additional analysis presented in Table 2, Panel D supports the hypothesis that practice risk impacts a tax professional's final recommendations. Specifically, at the low IRS oversight level, there is a statistically significant difference in recommendations between low and moderate practice risk (cells 1 versus 2 in Table 2, Panel A) and between moderate and high practice risk (cells 2 versus 3 in Table 2, Panel A), with tax professionals becoming significantly less aggressive moving from low to

---

[25] The authors find that tax professionals recommend away from the client-preferred treatment for both low and high practice risk.

moderate to high practice risk.[26] The results suggest that tax professionals recommend toward the more aggressive (client favorable) position for both low and moderate practice risk clients, which accounts for a significant proportion of the client population (64.20 percent + 31.33 percent).[27] Thus, in the low oversight condition, it appears that practice risk may only be an effective deterrent against aggressive decision making for high practice risk clients, which only accounts for a small population of taxpayers (6.04 percent).[28]

Additional analysis presented in Table 2, Panel D suggests that litigation has a significant impact on tax professionals. I am able to parse out the effects of unsuccessfully defended positions during prior IRS audits (moderate practice risk profile) from a history of litigation (high practice risk profile). By introducing a history of litigation only in the high practice risk profile, I demonstrate a strong negative reaction by tax professionals to taxpayer litigation. Specifically, at the low IRS oversight level, there is a statistically significant difference (p-value < .001) in recommendations between moderate and high practice risk clients (cells 2 versus 3 in Table 2, Panel A). While tax professionals are generally only liable for penalties and interest related to unsuccessful defended positions during IRS audits, litigation between a taxpayer and tax professional

---

[26] Kadous et al. (2008) manipulated practice risk, but did not manipulate the external regulatory environment. Therefore, I compare the results of their study to those of the low IRS oversight conditions.

[27] 144 tax professionals rated the perceived risk level of the low/moderate/high practice risk taxpayer profiles as 1.93/4.94/5.82 on a scale ranging from lowest (1) to highest (7) risk. They also noted the percent of similar clients of the low/moderate/high practice risk profiles as 64.20 percent/31.33 percent/6.04 percent on a 100 percent scale.

[28] As a manipulation check, I asked participants in this study to rate the riskiness of their given practice risk profile. The participants viewed the high practice risk scenario similar to participants in Kadous et al. (2008) given that participants in Kadous et al. (2008) rated the riskiness of the practice risk profile at 5.87 and the participants rated it at 5.82 on the same scale with values ranging from lowest (1) to highest (7) risk.

could represent a significant financial burden for tax professionals. The results demonstrate an intense reaction to the potential for litigation from a taxpayer and suggest that a history of litigation should be used on a very limited basis in future research due to the limited generalizability of any results.

Overall, the results suggest that practice risk impacts tax professionals' final recommendations, however, tax professionals only recommend strongly away from the client preferred position when facing high practice risk taxpayers. Given the results suggesting high practice risk clients represent only six percent of the client population, future research could examine whether expanded definitions of low and moderate practice risk deter confirmation bias and whether additional levels of practice risk impact other factors such as tax fees and client retention.

Advocacy – Practice Risk

H3b examines the prior finding that advocacy decreases as practice risk increases. I capture additional sensitivity to three levels of practice risk, finding evidence that varying levels of practice risk change reported advocacy levels ($F = 21.22$, $p < 0.001$). Similarly to Bobek et al. (2010), I find a significant difference between the moderate practice risk client (mean = 44.56) and high practice risk client (mean = 35.39). However, comparing the advocacy intentions toward the low practice risk client (mean = 44.64) and the moderate practice risk client (mean = 44.56), there is evidence to support a fairly substantial advocacy attitude, prevalent toward the majority of taxpayers.[29] Overall, the results suggest that tax professionals demonstrate a strong commitment to their professional role as client advocate for most tax clients.

Additional Analysis - Interaction of IRS Oversight and Practice Risk

Given that a tax professional considers both the regulatory environment and client characteristics in developing their final recommendations, I examine the possible interactive effects of IRS oversight and practice risk. The ANOVA results for the interaction between IRS oversight and practice risk are presented in Table 2, Panel B and are marginally significant at conventional levels ($F = 2.50$, $p = 0.086$). Figure 2 diagrams the disordinal interaction and illustrates that tax professionals are only willing to increase their levels of aggressiveness, in the presence of high IRS oversight, for moderate and high practice risk clients. Specifically, additional analysis presented in Table 2, Panel C suggests that the presence of high IRS oversight causes tax professionals to provide more aggressive recommendations for both moderate (cells 2 versus 5 in Table 2, Panel A) and high practice risk clients (cells 3 versus 6 in Table 2, Panel A). While, for low practice risk clients, high IRS oversight has no significant impact on a tax professional's recommendations (cells 1 versus 4 in Table 2, Panel A).[30]

---

[29] 144 tax professionals rated the percent of their clients that are similar to the low/moderate/high practice risk profiles as 64.20 percent/31.33 percent/6.04 percent on a 100 percent scale.

[30] This result is consistent with those of Cloyd and Spilker (1999). In that study, the authors manipulated the probability of IRS audit between subjects and found that the probability of audit had no significant effect on any of the dependent measures, including strength of recommendation.

[Insert Figure 2]

While these results suggest a counterintuitive outcome (i.e., that tax professionals are willing to fight for aggressive client positions for moderate and high practice risk clients, but not for low practice risk clients, when faced with high IRS scrutiny), anecdotal evidence from discussions with tax professionals and additional analysis of the results suggest that these results may be driven by tax professionals believing that moderate and high practice risk clients have a higher risk tolerance and thus are more willing to take an aggressive tax position in the presence of high IRS oversight. Specifically, tax professionals report the perceived client risk tolerance for the low, moderate, and high practice risk profiles as 3.84, 5.63, and 6.49, respectively, and the measures for client practice risk and perceived client risk tolerance are correlated at 0.703 ($p = 0.01$), supporting anecdotal evidence that the practice risk construct may be partially interpreted as a client's risk tolerance.[31] [32] In sum, the results suggest that a tax professional's desire to be more aggressive, as a reaction to increased control, appears to be tempered by the perceived willingness of a taxpayer to take an aggressive position. Future research should determine the specific attributes of moderate and high practice risk clients that may be causing tax professionals to view these clients as having a higher

[31] Each participant was asked to rate the client's perceived risk tolerance of their given client practice risk profile on a seven-point scale, with 1 indicating "Client is risk averse (not willing to take risks)" and 7 indicating "Client is risk seeking (willing to take significant risks)". Each tax professional received and responded to only one client practice risk profile.

[32] The intervals between each of these ratings were significant at $p < 0.001$

risk tolerance and, thus, more willing to be aggressive in the presence of high IRS oversight.

Additional Analysis - Non-ambiguous Decision Making

As a baseline control measure to validate the robustness of the results, I also examine a non-ambiguous decision-making scenario using a separate 2 x 3 ANOVA (IRS oversight risk by practice risk) with recommendation as the primary dependent variable. For the non-ambiguous decision scenario, tax professionals reported their business use recommendation on a one hundred percentage point scale, with 0 percent indicating no allowable business use deduction and 100 percent indicating a fully deductible business use deduction. Given the objective nature of the non-ambiguous decision, I expect to find no difference in decisions between low and high IRS oversight. Table 4 presents the results of the analysis.

[Insert Table 4]

Consistent with expectations, I find that increasing the level of IRS oversight has no significant impact on recommendations ($p = 0.222$) for the non-ambiguous decision. In further analysis, the only significant difference occurs in the analysis of simple effects between low and high IRS oversight for the low practice risk client. Specifically, tax professionals make a significantly more conservative recommendation for the low practice risk client when IRS oversight is high (mean = 91.54) than when IRS oversight is low (mean = 97.92, p = 0.014). These results support the previous discussion, indicating increased sensitivity to the perceived risk tolerance of the client, wherein tax professionals adjust the mean recommendation for the more risk averse client (low practice risk) in the face of high IRS oversight, but remain constant or more aggressive in their decisions for higher perceived risk tolerance clients (moderate and high practice risk).

2.7 Summary and Conclusions

The IRS has recently increased the scrutiny of tax professionals through the implementation of new direct oversight provisions, which include visits to tax preparer offices to review client files and to quiz tax preparers on the Internal Revenue Code. These recent provisions have focused on increasing the certainty of detection of aggressive tax reporting, which engages the third and final prong of deterrence theory. Although deterrence theory suggests that the certainty of detection is the most important factor in increasing compliance, extant literature on control theory suggests that increasing controls often has the unintended effect of causing an increase in the aggressive behaviors the controls aim to constrain. In addition to examining competing theories underlying tax preparer recommendations and client advocacy in the presence of these direct oversight initiatives, this paper also extends prior research on advocacy (Bobek et al. 2010; Mason and Levy 2001) and practice risk (Kadous et al. 2008; Kadous and Magro 2001).

I find evidence, consistent with the expectations of extant literature on control theory, that tax professionals increase the aggressiveness of their recommendations and report higher advocacy intentions when presented with high direct IRS oversight. These results are consistent with a tax practitioner's desire to challenge the IRS (Roberts 1998; Cuccia 1994b) and support the notion that the current IRS oversight program may not work as intended on the professional tax community. Additionally, the results suggest that client practice risk impacts tax professionals' final recommendations. Specifically, at low IRS oversight levels, tax professionals become significantly less aggressive moving from low to moderate to high practice risk. In sum, the interaction results suggest that, as tax professionals respond negatively to increased IRS scrutiny, the aggressiveness of their final recommendation appears to be tempered in some part by the client's perceived risk tolerance.

This study makes several contributions to the literature. First, I am the first to examine whether increased monitoring, under the IRS' new oversight initiatives, is useful in increasing tax compliance. Second, I extend prior research on advocacy, with results indicating a strong adherence to the professional standard of advocacy on the part of tax professionals, which stands in direct conflict with IRS attempts to use tax preparers as agents of taxpayer enforcement. Third, I provide expanded levels of practice risk, which provide evidence of the impact of specific client risk characteristics and should be beneficial to future research in this area. Finally, I find that the practice risk construct may be partially interpreted as a proxy for a client's risk tolerance, which may have a significant impact on the final recommendations of tax professionals.

This study is subject to certain limitations. First, this study suggests that client practice risk profiles may be partially interpreted as client risk tolerance perceptions but I did not examine these constructs separately. Future research could separately examine client practice risk and client risk tolerance perceptions to determine which has a greater influence in the decision-making process. Second, this study does not determine whether a tax professional's aggressive decision-making is a conscious or unconscious process. Future research could examine whether the decisions of tax professionals are consciously thought out and purposeful or whether tax professionals are unconsciously biased in their decision-making processes. This distinction would be particularly useful for practice management and future regulation as the profession attempts to limit penalties, sanctions, and litigation for overly aggressive tax reporting recommendations.

CHAPTER 3: ESSAY THREE

Tax Professionals and Antecedents to Aggressive Decision Making: An Examination of Client Identification and Economic Importance

3.1 Abstract

Prior research has found that tax professionals make aggressive recommendations for their clients, even under the threat of increased penalties and other costs. Thus, it is important to further understand *why* tax professionals may be willing to risk exposure to the increased costs of making aggressive recommendations for their clients. This paper examines the impact of two antecedents to aggressive decision-making, namely the role of the interpersonal relationship with the client (client identification) and the economic importance of the client, on the recommendations of tax professionals. Consistent with the tenets of Social Identity Theory, I find that stronger client identification leads to more aggressive recommendations and suggest that client identification is an important construct for future research in this area. Further, I find that a client's economic importance does not follow the presumed linear positive relationship with more aggressive recommendations. Rather the results suggest a nonlinear relationship between economic importance and aggressive recommendations, demonstrating a complex and multi-faceted response to economic importance.

3.2 Introduction

Prior research (Cuccia 1994; Roberts 1998; Cloyd and Spilker 1999; Hansen and White 2012; Vermeer 2012) has found that professional tax preparers make aggressive tax recommendations to their clients. While tax professionals are expected to be advocates for their clients (AICPA 2009), recommending aggressive tax positions poses a serious, and potentially costly, problem for the profession. Specifically, tax professionals and their firms face considerable exposure to professional sanctions and penalties as the Internal Revenue Service (IRS) works to tighten its monitoring of the tax profession through increased penalties, higher standards of care, and a new preparer oversight program. Additionally, tax professionals are exposed to the possibility of costly litigation and damage to their professional reputation when making aggressive tax recommendations. As the tax profession moves forward, it is important to further understand *why* tax professionals may be willing to risk exposure to these types of costs for their tax clients. Thus, the purpose of this paper is to examine the antecedents to aggressive decision making, specifically client identification and economic importance, and how these factors influence the decision making of tax professionals.

Drawing on the theory of economic dependence, prior tax literature presumes that client importance, conceptualized as the current and future income streams associated with a particular client, is the primary antecedent to aggressive tax decisions (Bobek, Hageman, and Hatfield 2010); however, studies examining client (economic) importance in the tax setting have found conflicting results.[1] Social Identity Theory (SIT), as well as interviews with practicing tax professionals[2], suggests that, in addition to economic importance, the strength of the interpersonal relationship with the client (client identification) is a prominent indicator of client importance. Social Identity Theory suggests that, as tax professionals develop strong interpersonal relationships (client identification) with their tax clients, the relationship may provide personal incentives which can compel aggressive (client favorable) tax reporting. Prior audit research supports this, finding that auditors who identify more with an audit client are more likely to acquiesce to a client-preferred position, demonstrate impaired objectivity, and contribute to perceived audit failures. (Nelson 2009; Bamber and Iyer 2007) Contrary to audit, in the tax environment, the majority of individual tax clients are often perceived as economically insignificant. Consequently, the construct of client identification may provide valuable insight into the incentives and aggressive decision making of tax professionals, beyond purely economic motivations. To my knowledge, this construct has not been examined in prior tax literature.

Prior tax research has assumed a linear relationship between economic importance and aggressive tax reporting, finding conflicting results on client (economic) importance.[3] While the theory of economic dependence (DeAngelo 1981) suggests that tax

---

[1] McGill (1990); Reckers et al. (1991); Bandy et al. (1994); Bobek et al. (2010)

[2] In interviews conducted with 23 tax professionals at a national tax conference in July 2011, tax professionals, independently and consistently, stated that the relationship with the client (both the instant ability to relate and the ongoing relationship were cited as equally important), the likability of the client, and the size of the fees earned from the client were reasons tax professionals would take aggressive positions for tax clients.

[3] McGill (1990); Reckers et al. (1991); Bandy et al. (1994); Roberts (1998); Bobek et al. (2010)

accountants have direct economic incentives to make aggressive client-preferred recommendations when the client is important (Roberts 1998), the countervailing incentives (Nelson 2009) of larger penalties, reputation loss, litigation costs, and increased litigation potential, may make the perceived costs of making more aggressive decisions exceed the benefits. Thus, as a client becomes more economically important, a non-linear relationship may develop as tax professionals reach a saturation point (i.e., where the risks of the countervailing incentives outweigh the rewards).

Using an experiment with practicing tax professionals, I manipulate client attributes at two levels (low/high) to stimulate client identification and manipulate economic importance (client fees) at three levels (low/moderate/high) in a full factorial design, measuring the effect on the main dependent variable of tax recommendations. Consistent with SIT, the results suggest that the strength of the client relationship (client identification) has a significant impact on the aggressiveness of recommendations at the low and moderate economic importance levels. Further, as suggested by the theory of economic dependence, economic importance is a significant factor in aggressive tax reporting moving from the low economic to moderate economic importance levels. However, in the high economic importance condition, tax professionals appear to curtail their aggressiveness back to levels consistent with those at the low economic importance level, demonstrating a nonlinear response to economic importance. Post experimental questions suggest that countervailing incentives, such as reputation protection and risk of economic loss, appear to overshadow both a client's economic importance and the effects of client identification at the high economic importance level.

The implications of the results are twofold: First, consistent with SIT, I introduce the construct of client identification in the tax environment and examine its importance as an antecedent motivation to a tax professional's aggressive decision making. Second, I extend the research on economic importance, finding that the antecedent motivator of economic importance is a complex multi-faceted issue and may not be the linear relationship presumed in prior research. Thus, the results on both client identification and economic importance may provide rationalization for the conflicting results on client importance in prior studies and should be fruitful for future accounting research.

The remainder of this paper proceeds as follows. Section II develops theory and hypotheses, Section III describes the research method, Section IV presents the results, and Section V concludes the paper.

3.3 Theory and Hypothesis Development

Tax accountants are expected to accept greater risks for aggressive reporting when the expected rewards of benefitting an important client are greater (Roberts 1998). While prior tax research has primarily defined client importance as the current and future income streams associated with a particular client (i.e., economic importance), Reid and Deaux (1996) suggest that tax professionals find intrinsic personal value and meaning by fulfilling their occupational roles. Further, SIT suggests that, as tax professionals develop stronger interpersonal relationships with their tax clients, the relationship may provide additional personal incentives which can compel aggressive tax reporting. In fact, interviews with practicing tax professionals suggest that the strength of the interpersonal relationship, as well as economic importance, are the two main facets of client importance. Thus, I manipulate and examine both client identification and economic importance in this study as main indicators of client importance and, thus, potentially strong antecedents to aggressive tax reporting.

Client Identification

I first examine the construct of client identification, or the strength of the interpersonal relationship between taxpayer and tax professional, which, according to the tenets of SIT, may produce compelling incentives for aggressive (client favorable) tax reporting. Social Identity Theory posits that a person's social identification is defined by their perceived membership in distinct real or imagined social groups, termed "ingroups". An individual may have several ingroup identities, typically classified through the person's vocation or organization (Turner 1978; Hogg and Terry 2000) or avocation (Underwood, Bond, and Baer 2001). Research in the social sciences has shown that, as a result of social identity, people typically evaluate members of their ingroups more favorably (Tajfel 1970, Tajfel 1978; Turner 1978), often leading to an alteration of the person's attitudes and behaviors which results in a favorable bias toward the perceived ingroup (Hogg and Terry 2000). Further, Reid and Deaux (1996) suggest that individuals experience "role-based" self-images, such as those created through occupation, which are restricted to a limited set of cognitive structures and involve well-developed personal interpretations of value, meaning, and performance styles that provide an overarching theme or integrity to personal identity.

Many elements of SIT are present in the relationship between tax preparer and tax client. Tax professionals often engage personally with clients in the preparation of tax returns and the completion of tax planning services, sometimes forming close personal ties with their tax clients. SIT suggests that these types of interpersonal relationships may create strong client identification, leading to favorable bias toward client preferred treatments, and may threaten a tax professional's ability to evaluate evidence objectively. Thus, stronger client identification may lead to the recommendation of aggressive tax positions, posing a serious, and potentially costly, situation for the tax professional and their firm.

Tax professionals have an inherent "role" as client advocate (AICPA 2009) and, according to Reid and Deaux (1996), tax professionals find intrinsic personal value and meaning by fulfilling their occupational role. Thus, in order to demonstrate their value and validate their personal identity, tax preparers may feel a need to consistently demonstrate their role as advocate, fighting with a strong bias toward client-favorable tax treatments when clients are perceived to have ingroup status (i.e., higher client identification).

Hence, according to the tenets of SIT, tax professionals will be more likely to recommend more aggressive client preferred tax positions for clients with whom they have stronger client identification, leading to the following hypothesis:

> H1: As client identification increases, tax professionals will be *more* likely to recommend more aggressive (client-favorable) tax positions.

Economic Importance

Drawing on the theory of economic dependence (DeAngelo 1981) and weighing the economic benefits and costs of an aggressive tax position (Roberts 1998, Figure 1), tax accountants have direct economic incentives to make recommendations consistent with client preference when the tax issue is ambiguous and the client is important (Roberts 1998). Thus, tax accountants are expected to accept greater risks for aggressive reporting when the expected reward from benefitting an important client is higher (Johnson 1993; Cuccia 1994, 1995; Cuccia, Hackenbrack, and Nelson 1995; Roberts 1998).

While prior tax literature presumes that client importance, conceptualized as the current and future income streams associated with a particular client, is associated with aggressive tax decisions (Bobek et al. 2010), prior studies examining client importance, as a purely economic incentive, have found conflicting results.[4] Early tax research examined client importance using general terms of "major" versus "minor" client (McGill 1990) and client gross income amounts and extent of past referrals (Reckers, Sanders, and Wyndelts 1991), finding that relative client importance is significantly associated with tax reporting decisions. Conversely, Bandy, Betancourt, and Kelliher

[4] The full definition of "client importance" in prior tax literature is "the current and future income streams associated with a particular client, either directly or through the influence on other clients". (Bobek et al. 2010)

(1994) isolate the impact of past referrals and find that the economic importance of a taxpayer has little or no effect on a tax professional's advice or willingness to sign an aggressive tax return. These early studies have received criticism for their operationalization of client importance (Roberts 1998).[5] A subsequent study by Bobek et al. (2010) finds that client (economic) importance does not affect advocacy intentions or recommendations for client preferred favorable tax treatments.[6]

While prior tax studies report mixed results on client (economic) importance, there is continued concern and theoretical justification regarding the potential impact of a client's economic importance on the decision making of tax and audit professionals. Further, the operationalization of client importance in the majority of these studies has received considerable criticism. Thus, this study experimentally manipulates three levels of economic importance, consistent with discrete client fee revenues suggested by the audit literature (Lowe and Pany 1995; Beattie, Brandt, and Fearnley 1999), leading to the following hypothesis:

> H2a: As a client's economic importance increases, tax professionals will be *more* likely to recommend more aggressive (client-favorable) tax positions.

---

5 See full discussion in Roberts (1998). Main criticisms include weak operationalization of importance between conditions, lack of ambiguity in the tax decision, lack of manipulation check to support results, confounds of client importance with client sophistication by varying occupation of taxpayers between treatments, etc.

6 Bobek et al. (2010) examine client importance and find that client importance does not affect client-specific advocacy or recommendations, but that it does have some effect on the weighting of evidence and the allowance of a favorable tax treatment.

While the theory of economic dependence suggests that, as clients become more economically important, audit professionals will cater to managements' financial reporting demands (Keune and Johnstone 2012) and, similarly, that tax professionals will be more likely to recommend more aggressive (client-favorable) tax positions (Roberts 1998; Bobek et al. 2010), research on countervailing incentives in audit (Nelson 2009) suggests there may be a limit to the effects of a client's economic importance on the decision making of accounting professionals. Specifically, as clients become more economically important, they also become larger and more visible. Thus, there is greater saliency of the potential costs of making aggressive decisions, such as exposure to larger penalties and increased exposure to reputation loss, litigation costs, and the overall potential for litigation, which could create a switch point, or a change in economic utility, wherein the costs of making more aggressive (client-favorable) decisions might be perceived to exceed the benefits.

In the tax environment, as a client gets larger, there is a steep increase in the risk of IRS audit (Kiplinger 2013).[7] Further, consistent with the countervailing incentive of reputation protection, Reynolds and Francis (2001) find that larger clients pose greater litigation risk causing Big 5 auditors to report more conservatively for more economically important clients. While the fear of litigation risk is economically acute in the audit environment, litigation risk poses a more common threat in the tax environment as tax practice litigation claims presented by Continental Casualty Co. (CNA) generated nearly

---

[7] The IRS audit rates for individual taxpayers with income below $200,000 is less than one percent (0.94%); however, the audit rate for individual taxpayers making over $200,000 of income jumps to 3.70% (1 in 27 returns) and for individuals making income of $1 million or more, the audit rate is greater than 12.5% (or greater than 1 in 8 returns).

60 percent of AICPA program claims for the period 1996-2001 (Anderson and Wolfe 2002).[8] Additionally, penalties for tax professionals under Internal Revenue Code (IRC) Section 6694 are based on the income derived from the client (i.e., the fees received from the client).[9] Thus, the larger the fee generated from the tax client, the greater the risk of substantial economic loss. In sum, these countervailing incentives may create a disincentive for tax professionals to recommend aggressive tax positions to more economically important clients.

Prior tax literature has presumed a linear relationship between a client's economic importance and aggressive tax reporting (Roberts 1998; Bobek et al. 2010). To my knowledge, tax literature has not examined the potential for a nonlinear relationship between client importance and aggressive tax reporting. Specifically, (as illustrated in Figure Three) at some point, the potential costs (countervailing effects) exceed the incentives of client (economic) importance, leading to a reduction in aggressive tax reporting. Consistent with the foregoing discussion, as countervailing incentives create potential costs that may be perceived as exceeding the benefits of a client's economic importance, a nonlinear relationship between client (economic) importance and a tax professional's recommendation may develop, leading to the following hypothesis:

---

[8] CNA is the underwriter of the AICPA professional liability insurance program. The breakout of claims data occurred for the period 1996-2001.

[9] Internal Revenue Code Section 6694 sets the preparer level penalties for underreported tax liabilities due to unreasonable tax positions or willful or reckless conduct. First-tier penalties (for unreasonable positions) were increased from $250 to the greater of $1000 or 50 percent of the income derived by the tax return preparer. Second-tier penalties (for willful or reckless conduct) were increased from $1000 to the greater of $5000 or 50 percent of the income derived by the tax return preparer. The "realistic possibility standard" required a one-in-three likelihood that the reported tax position would be sustained on its merits, while the increased "more likely than not standard" requires a better than 50 percent chance that the reported tax position will be sustained on its merits and the "substantial authority standard" has been interpreted as approximately 40 percent (Pauly 2008).

H2b: At some level of economic importance, tax professionals will be *less* likely to recommend more aggressive (client favorable) tax positions as a client's economic importance increases.

[Insert Figure 3]

3.4 Research Methodology

I examine the hypotheses using an experiment in which tax professionals are asked to make a recommendation on a hobby versus business tax decision (an ambiguous client fact scenario). Both client identification (2 levels) and economic importance (3 levels) are manipulated between participants within the experimental materials.

Participants

Participants are practicing tax professionals recruited at a national tax conference.[10] This method of recruitment provides for a large sample of experienced tax professionals who regularly deal with and make decisions on individual taxpayer issues and who are unlikely to be biased by geographic location or any singular firm size, training, or practice philosophy. I recruited 136 participants out of 237 in attendance (57.4% response rate) at the conference. Of those, three participants failed manipulation checks or had incomplete data, resulting in 133 usable participant instruments.

[10] Approval was granted for the use of human subjects in this experiment by the institution where this experiment was conducted.

As presented in Table 5, the experience level ranges from 6 months (0.5 years) to 480 months (20 years), with a mean experience level of 85.20 months (7.10 years); 52.6 percent were male; 48.1 percent possess an advanced degree; and 84.2 percent hold a current CPA license. Participants are employed by national accounting firms (12.1 percent), regional accounting firms (52.3 percent), and local accounting firms (35.6 percent).[11]

[Insert Table 5]

Experimental Design

The experiment employs a 2 x 3 full factorial design, manipulating two levels of client identification (low and high) and three levels of economic importance (low/moderate/high) between participants.

In this study, the low client identification condition is manipulated with the following statement: "You receive all your information about these clients through the partner on this engagement and, as such, you do not have personal contact with the taxpayers." and the high client identification condition is manipulated with the following statement: "Joanne has been your pharmacist for the past seven years and when John and Joanne were selecting a new tax preparer, you brought them in as clients of your firm. As such, you meet individually with the taxpayers each year, serve as their primary point

[11] There is not a significant difference in mean recommendations between firm types.

of contact with your firm, and you have established a friendly relationship with the clients."

The three levels of economic importance (low/moderate/high) are defined consistent with prior audit research (Lowe and Pany 1995; Beattie et al. 1999).[12] Specifically, low economic importance is defined as a client with total fees of less than one percent (1%) and high economic importance is defined as a client with total fees of 12 percent (12%) or greater. I also include an intermediate value (moderate economic importance) of six percent (6%) to determine if there is variation between the low and high values.

Experimental Procedures

Participants were provided with a research instrument containing brief directions and a basic client profile with the manipulations of client identification (low/high) crossed with the manipulations of economic importance (low/moderate/high) in a full factorial 2 x 3 experimental design. Participants were then presented with basic information about the taxpayers[13] and the pertinent facts about the taxpayers' business versus hobby tax issue.[14] In the tax case, the taxpayers would like to deduct $31,000 of expenses related to songwriting activities during the year; thus, they prefer that the songwriting activities be treated as a business so the related expenses can be deducted on

---

[12] Prior audit research defines an economically material client as a client with fees of ten percent (10%) or greater of office revenues (Beatty et al. 1999) or twelve percent (12%) or greater of office revenues (Lowe and Pany 1995) and an economically immaterial client as a client with fees of less than one percent (1%).
[13] To ensure consistent interpretation of the client risk profile, I use a low practice risk profile consistent with that used in prior research (Kadous and Magro 2001; Vermeer 2012)
[14] See Appendix A for an excerpt of the tax issue from the experimental materials

their tax return (hobby related expenses are not deductible).[15] After reviewing the case, the participants were referred to appropriate regulatory support for making a decision (IRS regulations) and asked to make a business/hobby recommendation for the taxpayers.

Then, participants were asked to answer questions about the confidence of their decision, familiarity with the business/hobby decision, manipulation check questions, and other questions related to the decision and client profile. Participants then completed the Mason and Levy (2001) advocacy scale specific to their client scenario[16] and SIT scales (Mael and Ashforth 1992; Bhattacharya, Rao, and Glynn 1995; Russo 1998; Bamber and Iyer 2007) measuring client identification, professional identification, and firm identification.

Finally, participants were asked to answer demographic questions, including months of experience as a tax professional, type of firm, CPA/non-CPA, gender, type of degree, and age. As an added validation measure, I asked respondents to answer multiple-choice questions, in a post-experimental survey, indicating the likelihood of success if the recommendation is challenged, familiarity with the current penalty and standards of care required of practicing tax professionals under IRC Section 6694, and questions supporting their decision process. The post-experimental design is used to ensure that the participants are knowledgeable about the current regulatory standards

---

[15] Prior studies (Cloyd and Spilker 1999) have found that client preference induces bias. I hold client preference constant across all manipulations to isolate the effects of the manipulated variable from the effects of client preference induced bias.

[16] Consistent with the concept of client-specific advocacy introduced by Bobek et al. (2010), the Mason and Levy (2001) advocacy scale was administered by replacing the general term "taxpayer" with the hypothetical client names for each item on the scale.

applicable to their decisions and to obtain information supporting their decision factors, but to avoid biasing their answers within the experimental materials.

Independent Variables, Covariates, and Dependent Variable

There were two independent variables manipulated between participants: client identification (low and high) and economic importance (low/moderate/high). The manipulation checks for these variables are described below. Participants' gender and familiarity with the decision are included as covariates.

Gender and decision familiarity are included in the ANCOVA model because they have been found to have an impact on decision-making in prior research (McGill 1990; Reckers et al. 1991; Roberts 1998; Hansen and White 2012) and are significant variables in the model. Although these covariates contribute to the overall power of the model, their inclusion does not substantially alter the main effects of the study (ANOVA model without gender and decision familiarity as covariates, $F = 3.371$, $p = 0.007$). The mean recommendation for males is 7.16 while the mean recommendation for females is 5.54 ($t = 3.981$, $p < 0.001$). This result on gender is consistent with prior research indicating that males are less risk averse than females (McGill 1990; Hansen and White 2012). The mean for decision familiarity (decision experience) is 3.42 on a scale of 1 to 7, with 1 indicating "never" and 7 indicating "frequent" participation, with 86.6 percent of the participants indicating they participate in business/hobby decisions for current tax clients.[17] Thus, participants are well suited for the experimental task.

There was one primary dependent variable: (1) the recommendation of the tax position. Additional dependent variables are considered in the manipulation checks and additional analysis sections.

Manipulation Checks

The effectiveness of the client identification manipulation was assessed via participants' responses to a five-item client identification scale, adapted from Bamber and Iyer (2007) and Bhattacharya et al. (1995). The five-item client identification scale[18] captures the degree of identification with the client, consistent with SIT. The total client identification score was computed by summing up the responses to the five-item scale, with a total client identification score ranging between 5 and 25. The mean (standard deviation) for the total client identification score is 13.33 (4.32) in the low client identification condition, compared with 16.85 (4.83) in the high client identification condition. The difference in means is significant between the low and high client identification conditions ($F = 18.97$; $p < 0.001$), indicating a successful manipulation of client identification.

To examine the effectiveness of the economic importance manipulations, I asked participants to indicate whether the client represented an economically important client

---

[17] Task specific familiarity has been found to be a significant measure impacting differences in judgment and decision-making (Reckers et al. 1991; Roberts 1998).

[18] The five-item client identification scale is presented in Appendix B.

on a 7-point Likert scale, with 1 indicating "not economically important" and 7 indicating "extremely economically important". The mean (standard deviation) responses are 2.11 (1.30) for the low economic importance condition, 4.40 (1.72) for the moderate economic importance condition, and 5.29 (1.56) for the high economic importance condition. Overall, these differences in means are statistically significant ($F = 51.63$, $p < 0.001$) and t-test results indicate significant differences between the low and moderate economic condition ($t = 7.16$, $p < 0.001$), significant differences between the moderate and high economic condition ($t = 2.70$, $p = 0.024$), and significant differences between the low and high economic condition ($t = 9.73$, $p < 0.001$). In sum, these results indicate a successful manipulation of economic importance.

To ensure that the business versus hobby tax case in my experimental materials involved an ambiguous decision scenario and that choosing business treatment is considered an aggressive tax position, I asked participants to respond to a post-experimental question about the likelihood that *business treatment* of the tax issue would be sustained on its merits. Participants responded on a scale, indicating zero percent (not likely at all to be sustained) to one hundred percent (extremely likely to be sustained). The mean (standard deviation) response to the likelihood that business treatment would be sustained on its merits is 24.47 (15.42), with a minimum rating of zero and a maximum rating of seventy. This response indicates that making a recommendation for business treatment is an aggressive decision for the experimental tax case.[19] Further,

---

[19] To ensure that participants understood the professional standards and penalties currently in place regarding aggressive decision making, I asked two post-experimental multiple choice questions asking

35.8% of the participants recommended hobby treatment in the study while 64.2% recommended business treatment in the study. These responses demonstrate a sufficient level of ambiguity in the decision process.

3.5 Results

Hypotheses are tested using a 2 x 3 ANCOVA (client identification by economic importance) with recommendation as the primary dependent variable. In this study, tax professionals report their recommendations on a ten-point, forced decision scale, with 1 indicating "Definitely Hobby" and 10 indicating "Definitely Business". The ANCOVA results for the model are presented in Table 6, Panel B and are significant at conventional levels ($F = 7.09$, $p < 0.001$).

Client Identification

Consistent with the expectations of SIT, H1 predicts that tax professionals will be *more* likely to recommend more aggressive (client-favorable) tax positions as client identification increases. Mean recommendations by experimental condition are presented in Table 6, Panel A and support H1, indicating a significant positive relationship between increased client identification and more aggressive (client-favorable) recommendations (overall mean of 6.93 in the high client identification

---

participants to identify (1) the current professional standard applicable to this decision and (2) the current penalties in place under IRC Section 6694. Respondents successfully indicated the correct penalty (91.7 percent) and the correct standard(s) (94 percent), indicating an overall familiarity with the standards and penalties applicable to the business/hobby recommendation.

condition and overall mean of 5.85 in the low client identification condition; $F = 8.14$, $p = 0.005$). Overall, consistent with the expectations of SIT and anecdotal evidence from the profession, these results suggest that tax professionals are more likely to make more aggressive recommendations for clients with whom they feel stronger client identification.

[Insert Table 6]

High client identification appears to have the greatest impact when a client's economic significance is low (mean recommendation of 6.83 for high client identification condition and 5.05 for low client identification condition; $F = 4.08$, $p = 0.049$) or moderate (mean recommendation of 7.82 for high client identification condition and 6.57 for low client identification condition; $F = 4.90$, $p = 0.032$). Conversely, high client identification does not substantially alter the recommendation for clients with high economic significance (mean recommendation of 6.10 for high client identification condition and 5.90 for low client identification condition; $F = 0.085$, $p = 0.772$). In advance of the discussion of economic importance below, this result suggests that the effects of high client identification reach a saturation point, where the effects of client identification seem to recede and tax professionals curtail their aggressiveness back to a level similar to the low client identification condition. I will discuss these results in further detail in the economic importance and supplementary analysis sections below. Overall, the construct of client identification appears to be an important antecedent of aggressive decision making in the tax environment, which exists independent of a client's economic importance, and is especially salient at the low and moderate economic importance levels.

Economic Importance

Consistent with the theory of economic dependence and prior tax literature, H2a predicts that tax professionals will make *more* aggressive (client-favorable) recommendations as a client's economic importance increases (a linear positive relationship). Contrary to the linear relationship hypothesized in H2a, H2b predicts that, at some level of economic importance, tax professionals will make *less* aggressive (client-favorable) recommendations as economic importance increases. In other words, the positive relationship between a client's economic importance and a tax professional's increase in aggressive recommendations may not continue in perpetuity. Instead, the countervailing incentives of reputation protection and the risk of economic loss from penalties and litigation may, at some point, create a disincentive that overshadows the client's economic importance, creating a nonlinear relationship between economic importance and aggressive decision making.

[Insert Figure 4]

Figure 4 diagrams the mean recommendation by treatment condition and suggests that these results provide partial support for H2a, namely that tax professionals make *more* aggressive (client-favorable) recommendations as a client's economic importance increases. As presented in Table 6, Panel C, there is a statistically significant positive difference (t = 3.10, p = 0.002) between the recommendations for the low and moderate economic conditions, with a mean (standard deviation) recommendation for the low economic importance condition of 5.98 (3.01) and a mean recommendation of 7.18 (1.98) for the moderate economic importance condition. Overall, as suggested by the theory of economic dependence, tax professionals do react, at least partially, to a client's economic importance.

Although the results provide partial support for H2a, the results fully support H2b, namely that, at some level of economic importance, tax professionals will make *less* aggressive (client-favorable) recommendations as a client's economic importance increases. Specifically, as diagrammed in Figure 4, the effects of economic importance seem to recede at the high economic importance level as tax professionals curtail their aggressiveness back to levels consistent with those of the low economic importance level. As presented in Table 6, Panel C, there is a statistically significant negative difference (t = 3.01, p = 0.003) between the recommendations for the moderate and high economic conditions, with a mean (standard deviation) recommendation for the medium economic importance condition of 7.18 (1.98) and a mean recommendation of 6.00 (2.09) for the high economic importance condition. In fact, the mean recommendation of 6.00 for the high economic condition is not statistically different (t = 0.02, p = 0.984) than the mean recommendation of 5.98 for the low economic importance condition. In sum, these results support H2b, indicating a nonlinear response to economic importance, with tax professionals becoming less aggressive as the countervailing incentives of reputation protection and risk of economic loss overshadow a client's economic importance.

To further examine the impact of countervailing economic incentives on tax professional decision making at each level of economic importance, participants were asked (in a post-experimental questionnaire) to respond to three scales indicating how important the following three issues were in making their recommendation decision: (1) risk of economic loss from penalties and litigation, (2) risk of loss of professional reputation, and (3) maintaining the relationship with the client.[20] Participants responded to each question on a seven point Likert scale, with 1 indicating "not important" and 7 indicating "extremely important". For the (1) risk of economic loss question, there is a statistically significant difference ($p < 0.001$) between the [mean (standard deviation)] responses for the moderate economic importance condition [3.84 (1.18)] and the high economic importance condition [5.57 (1.17)].[21] This result indicates greater saliency of the increased risk of economic loss in the high economic importance condition, supporting the decrease in aggressive recommendations found in my study at the highest level of economic importance. The results on the (2) risk of loss of professional reputation question are similar, with a statistically significant difference ($p < 0.001$) between the [mean (standard deviation)] responses for the moderate economic importance condition [4.09 (1.14)] and the high economic importance condition [5.76

[20] The overall mean (standard deviation) for the third question (maintaining relationship with the client) is 4.38 (1.13) and the means between each condition are not significantly different at $p < 0.05$.
[21] The means for the low economic importance condition are not significantly different from the moderate economic importance condition.

(1.16)].[22] Thus, suggesting an increase in perceived exposure to loss of professional reputation. Overall, these results provide additional support for a potential shift in decision making and corollary decrease in aggressive recommendations found in the high economic importance conditions. Future research could examine at what point this shift in decision making occurs and isolate which countervailing incentives, solely or in tandem, may be the most important factors in the tax environment.

Supplemental Analysis

Advocacy "is a state of mind in which one feels one's primary loyalty belongs to the taxpayer. It is exhibited by a desire to represent the taxpayer zealously within the bounds of the law, and by a desire to be a fighter on behalf of the taxpayer" (Mason and Levy 2001). Building on a significant amount of research linking client advocacy to professional recommendations and judgments [Mason and Levy 2001; Bobek et al. 2010 (literature review of advocacy studies); Hansen and White 2012], I measure participant responses to the Mason and Levy (2001) advocacy scale, using the construct of client-specific advocacy introduced by Bobek et al. (2010).[23]

Overall, I find that advocacy is not correlated with economic importance ($F = 0.210$, $p = 0.811$). This result is consistent with the finding in Bobek et al. (2010) that higher client importance, defined in purely economic terms, does not affect advocacy

---

[22] The means for the low economic importance condition are not significantly different from the moderate economic importance condition.

[23] Consistent with the concept of client-specific advocacy introduced by Bobek et al. (2010), the Mason and Levy (2001) advocacy scale was administered by replacing the general term "taxpayer" with the hypothetical client names for each item on the scale.

intentions. Conversely, my results do indicate a significant positive relationship between increased client identification and increased advocacy scores (overall mean of 45.22 in the high client identification condition and overall mean of 42.88 in the low client identification condition; $F = 4.22$, $p = 0.042$).[24] Thus, client identification does appear to significantly impact client advocacy and may be an important determinant of overall client importance.

3.6 Summary and Conclusions

While tax professionals are expected to be advocates for their clients (AICPA 2009), recommending aggressive tax positions poses a serious, and potentially costly, problem for the profession. Although the risk of litigation is economically acute in the audit environment, litigation risk poses a more common threat in the tax environment as tax practice litigation claims generated nearly 60 percent of the AICPA program insurance claims for the period 1996-2001 (Anderson and Wolfe 2002). Additionally, penalties for tax professionals under IRC Section 6694 are based on the income derived from the client (i.e., the fees received from the client). Moving forward, it is important to further understand *why* tax professionals may be willing to risk exposure to these types of costs for their tax clients. Thus, this paper examines the impact of two antecedents to aggressive decision-making, namely the role of the interpersonal relationship with the

---

[24] The client specific advocacy scores for my participants ranged from 24 (low advocacy) to 60 (high advocacy), with a mean score of 42.88 for the low client identification condition. This compares to means of 42.20 in the Mason and Levy (2001) study, 42.43 in the Bobek et al. (2010) study, and 43.20 in the Hansen and White (2012) study.

client (client identification) and the economic importance of the client, on the recommendations of tax professionals.

Using an experiment with practicing tax professionals at a national tax conference, I manipulate client attributes at two levels (low/high) to stimulate client identification and manipulate economic importance (client fees) at three levels (low/moderate/high) in a full factorial design, measuring the effect on the main dependent variable of tax recommendations. Consistent with SIT, the results suggest that the strength of the client relationship (client identification) has a significant impact on the aggressiveness of recommendations at the low and moderate economic importance levels. Further, as suggested by the theory of economic dependence, economic importance is a significant factor in aggressive tax reporting moving from the low economic to moderate economic importance levels. However, in the high economic importance condition, tax professionals make less aggressive recommendations, back to levels consistent with those at the low economic importance level, demonstrating a nonlinear response to economic importance. Post experimental questions suggest that countervailing incentives, such as reputation protection and risk of economic loss, appear to overshadow both a client's economic importance and the effects of client identification at the high economic importance level.

The implications of these results are twofold: First, consistent with SIT, I introduce the construct of client identification in the tax environment and examine its importance as an antecedent motivation to a tax professional's aggressive decision making. Second, I extend the research on economic importance, finding that the antecedent motivator of economic importance is a complex multi-faceted issue and may not be the linear relationship presumed in prior research. Thus, the results on both client identification and economic importance may provide rationalization for the conflicting results on client importance in prior studies and should be fruitful for future accounting research. Specifically, future research should examine at what point tax professionals "switch" and make less aggressive (client-favorable) recommendations as economic importance increases and which potential costs, such as reputation protection or the risk of economic loss, may be the prevailing reason for the switch.

The results of this study are subject to certain limitations. The results may be specific to the business/hobby issue presented in the tax case and may not apply generally to all ambiguous tax issues. Additionally, this study examines the impact of antecedents on a tax professional's final recommendations and does not consider the impact on the allowance of aggressive positions, on the willingness to sign the tax return, or on information search (Cloyd and Spilker 1999; Bobek et al. 2010; Hansen and White 2012). Future research could address these limitations.

LIST OF REFERENCES – ESSAY ONE

Alexander, R. 2003. The Effects of Source Credibility on Tax Professionals Judgment in Consulting Engagements. The Journal of the American Taxation Association 25 (Supplement), 33-49.

Anderson, S. and Cuccia, A. 2000. A Closer Examination of the Economic Incentives Created by Tax Return Preparer Penalties. The Journal of the American Taxation Association 22 (1), 56-77.

Barrick, J., Cloyd, C., and Spilker, B. 2004. The Influence of Biased Tax Research Memoranda on Supervisors' Initial Judgments in the Review Process. The Journal of the American Taxation Association 26 (1), 1-19.

Bobek, D. and Hatfield, R. 2003. An Investigation of the Theory of Planned Behavior and the Role of Moral Obligation in Tax Compliance. Behavioral Research in Accounting (15), 13-37.

__________, Hageman, A., and Hatfield, R. 2010. The Role of Client Advocacy in the Development of Tax Professionals' Advice. The Journal of the American Taxation Association 32 (1), 25-51.

Boylan, S. and Sprinkle, G. 2001. Experimental Evidence on the Relation between Tax Rates and Compliance: The Effect of Earned vs. Endowed Income. The Journal of the American Taxation Association 23 (1), 75-90.

___________ and Frischmann, P. 2006. Experimental Evidence on the Role of Tax Complexity in Investment Decisions. The Journal of the American Taxation Association 28 (2), 69-88.

___________. 2010. Prior Audits and Taxpayer Compliance: Experimental Evidence on the Effect of Earned Versus Endowed Income. The Journal of the American Taxation Association 32 (2), 73-88.

Carnes, G. and Cuccia, A. 1996. An Analysis of the Effect of Tax Complexity and its Perceived Justification on Equity Judgments. The Journal of the American Taxation Association 18 (2), 40-56.

Christensen, A. and Hite, P. 1997. A Study of the Effect of Taxpayer Risk Perceptions on Ambiguous Compliance Decisions. The Journal of the American Taxation Association 19 (1), 1-18.

Cloyd, C. and Spilker, B. 1999. The Influence of Client Preferences on Tax Professionals' Search for Judicial Precedents, Subsequent Judgments and Recommendations. The Accounting Review 74, 299-322.

_________ and ____________. 2000. Confirmation Bias in Tax Information Search: A Comparison of Law Students and Accounting Students. The Journal of the American Taxation Association 22 (2), 60-71.

Copeland, P. and Cuccia, A. 2002. Multiple Determinants of Framing Referents in Tax Reporting and Compliance. Organizational Behavior and Human Decision Process 88 (1), 499-526.

Cuccia, A. 1994. The economics of tax compliance: What do we know and where do we go? Journal of Accounting Literature (13), 81.

___________ and Carnes, G. 2001. A Closer Look at the Relation Between Tax Complexity and Tax Equity Perceptions. Journal of Economic Psychology 22, 113-140.

Davis, J. and Mason, D. 2003. Similarity and Precedent in Tax Authority Judgment. The Journal of the American Taxation Association 25 (1), 53-71.

Ghosh, D. and Crain, T. 1995. Ethical standards, attitudes toward risk, and intentional noncompliance: an experimental investigation. Journal of Business Ethics (14): 353-365.

Guy, S. 2010 Paid tax preparers must obtain user ID number: IRS. Chicago Sun-Times, November 12.

Hanno, D. and Violette, G. 1996. An Analysis of Moral and Social Influences on Taxpayer Behavior. Behavioral Research in Accounting (8), 57-75.

Hatfield, R. 2001. The Effect of Staff Accountant Objectivity in the Review and Decision Process: A Tax Setting. The Journal of the American Taxation Association 23 (1), 61-74.

Haynes, C., Jenkins, J. and Nutt, S. 1998. The Relationship Between Client Advocacy and Audit Experience: An Exploratory Analysis. Auditing: A Journal of Practice & Theory 17 (2), 88-104.

Internal Revenue Service (IRS) 2010$_a$. Return Preparer Letter – Filing Season 2011, November 22. Available at http://www.irs.gov/businesses/small/article/0,,id=231826,00.html

Internal Revenue Service (IRS) 2010$_b$. SOI Tax Stats – SOI Bulletin: Winter 2010, March 4. Available at http://www.irs.gov/taxstats/article/0,,id=219330,00.html

Internal Revenue Service (IRS) 2009a. IRS Launches Tax Return Preparer Review; Recommendations to Improve Compliance Expected by Year End, June 4. Available at http://www.irs.gov/newsroom/article/0,,id=209375,00.html

Internal Revenue Service (IRS) 2009b. Fiscal Year 2007 Enforcement and Services Results, January 16. Available at http://www.irs.gov/newsroom/article/0,,id=177701,00.html

Internal Revenue Service (IRS) 2006. The Tax Gap. February 14. Available at http://www.irs.gov/newsroom/article/0,,id=158619,00.html

Jackson, B. and Milliron, V. 1986. Tax Compliance Research: Findings, Problems, and Prospects. Journal of Accounting Literature (5), 125-165.

Kadous, K. and Magro, A. 2001. The effects of exposure of practice risk on tax professionals' judgments and recommendations. Contemporary Accounting Research 18 (3), 451-475.

____________. ______________. and Spilker, B. 2008. Do Effects of Client Preference on Accounting Professionals' Information Search and Subsequent Judgments Persist with High Practice Risk? The Accounting Review 83 (1), 133-156.

Kahle, J. and White, R. 2004. Tax Professional Decision Biases: The Effects of Initial Beliefs and Client Preference. The Journal of the American Taxation Association 26 (1), 1-29.

Kaplan, S., Newberry, K., and Reckers, P. 1997. The Effect of Moral Reasoning and Educational Communications on Tax Evasion Intentions. The Journal of the American Taxation Association 19 (2), 38-54.

Magro, A. 1999. Contextual Features of Tax Decision-Making Settings. The Journal of the American Taxation Association 21 (Supplement), 63-73.

___________ and Stetson, B. 2004. Tax Decision Making under the New Burden of Proof Rules. The Journal of the American Taxation Association 26 (2), 23-42.

___________. 2005. Knowledge, Adaptivity, and Performance in Tax Research. The Accounting Review 80 (2), 703-722.

Mason, J. and Levy, L. 2001. The use of the latent constructs method in behavioral accounting research: The measurement of client advocacy. Advances in Taxation 13: 123-139.

Pinsker, R., Pennington, R., and Schafer, J. 2009. The Influence of Roles, Advocacy, and Adaptation to the Accounting Decision Environment. Behavioral Research in Accounting 21 (2), 91-111.

Porcano, T. 1988. Correlates of Tax Evasion. Journal of Economic Psychology (9), 47-67.

____________ and Price, C. 1993. The effects of social stigmatization on tax evasion. Advances in Taxation (5), 197-217.

Reckers, P., Sanders, D., and Roark, S. 1994. The Influences of Ethical Attitudes on Taxpayer Compliance. National Tax Journal.

Roberts, M. 1998. Tax Accountants' Judgments/Decision-Making Research: A Review and Synthesis. The Journal of the American Taxation Association 20 (1), 78-121.

Rupert, T. and Wright, A. 1998. The Use of Marginal Tax Rates in Decision Making: The Impact of Tax Rate Visibility. The Journal of the American Taxation Association 20 (2), 83-99.

___________, Single, L. and Wright, A. 2003. The Impact of Floors and Phase-Outs on Taxpayers' Decisions and Understanding of Marginal Tax Rates. The Journal of the American Taxation Association 25 (1), 72-86.

Spilker, B., Worsham, R., and Prawitt, D. 1999. Tax Professionals' Interpretations of Ambiguity in Compliance and Planning Decision Contexts. The Journal of the American Taxation Association 21 (2), 75-89.

Stephenson, T. 2007. Do Clients Share Preparers' Self-Assessment of the Extent to Which They Advocate for Their Clients? Accounting Horizons 21 (4), 411-422.

U.S. Department of the Treasury (U.S. Treasury) 2009. Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance, July 8. Available at http://www.irs.gov/pub/newsroom/tax_gap_report_-final_version.pdf

Vines, C. and Wartick, M. 2003. Tax-Reporting Implications of Asymmetric Treatment: Direct Subsidies vs. Tax Deductions. The Journal of the American Taxation Association 25 (1), 87-99.

Wartick, M., Madeo, S., and Vines, C. 1999. Reward Dominance in Tax-Reporting Experiments: The Role of Context. The Journal of the American Taxation Association 21 (1), 20-31.
Watts, R. and Zimmerman, J. 1978. Towards a Positive Theory of the Determination of Accounting Standards. The Accounting Review (January): 112-134.

Weigel, R., Hessing, D., and Elffers, H. 1987. Tax Evasion Research: A Critical Appraisal and Theoretical Model. Journal of Economic Psychology (8), 215-235.

White, R., Harrison, P., and Harrell, A. 1993. The Impact of Income Tax Withholding on Taxpayer Compliance: Further Empirical Evidence. The Journal of the American Taxation Association 15 (Fall), 63-78.

Zimmerman, J., 1977. The Municipal Accounting Maze: An Analysis of Political Pressure. Journal of Accounting Research 15, 107-144.

LIST OF REFERENCES – ESSAY TWO

American Institute of Certified Public Accountants (AICPA). 2009. Statements on Standards for Tax Services. November 2009.

Anderson, S. and A. Cuccia. 2000. A closer examination of the economic incentives created by tax return preparer penalties. *The Journal of the American Taxation Association* 22 (1): 56-77.

Becker, G. S. 1968. Crime and punishment: An economic approach. *Journal of Political Economy* 78: 169-217.

Bobek, D., A. Hageman, and R. Hatfield. 2010. The role of client advocacy in the development of tax professionals' advice. *The Journal of the American Taxation Association* 32 (1): 25-51.

Butterfield, S. 2002. *Deterrence theory and tax compliance: the impact of a reduction in IRS enforcement activities*. PhD dissertation, Georgia State University. Ann Arbor: ProQuest/UMI. (Publication No. UMI 3073671)

Christ, M.H. 2008. *Intending to control: an experimental investigation of the interactions among intentions, reciprocity and control*. PhD dissertation, The University of Texas at Austin. Ann Arbor: ProQuest/UMI. (Publication No. UMI 3311443)

__________, Sedatole, K.L., and K.L. Towry. 2006. All control is not equal: the effect of formal control type on trust and cooperation. AAA Management Section (MAS) 2006 Meeting Paper.

__________, ___________, ______________, and M.A. Thomas. 2008. When formal controls undermine trust and cooperation. *Strategic Finance*: 39-44.

Cloyd, C., and B. Spilker. 1999. The influence of client preferences on tax professionals' search for judicial precedents, subsequent judgments and recommendations. *The Accounting Review* 74: 299-322.

Cuccia, A. 1994a. The Effects of Increased Sanctions on Paid Tax Preparers: Integrating Economic and Psychological Factors. *The Journal of the American Taxation Association* 16 (1): 41-66.

Cuccia, A. 1994b. The economics of tax compliance: What do we know and where do we go? *Journal of Accounting Literature* (13): 81.

Davis, J. S. and J. D. Mason. 2003. Similarity and precedent in tax authority judgment. *The Journal of the American Taxation Association* 25 (1): 53-71.

Decker, S., and C. W. Kohfeld.1990. Certainty, severity, and the probability of crime: A logistic analysis. *Policy Studies Journal* 19 (1): 2-21.

Eide, E. 1994. *Economics of crime: Deterrence and the rational offender*. Amsterdam: North Holland.

Falk, A. and M. Kosfeld. 2006. The hidden costs of control. *The American Economic Review* 96 (5): 1611-1630.

Internal Revenue Service (IRS) 2011a. Publication 4822 (04-2011) Catalog Number 54312P Department of the Treasury Internal Revenue Service.

___________________________ 2011b. IRS Letters and Visits to Return Preparers – Filing Season 2011, January 14. Available at http://www.irs.gov/businesses/small/article/0,,id=231925,00.html

___________________________ 2011c. IRS Letters and Visits to Return Preparers – FAQs Filing Season 2012, December 7. Available at http://www.irs.gov/taxpros/article/0,,id=249075,00.html

___________________________ 2010a. Return Preparer Letter – Filing Season 2011, November 22. Available at http://www.irs.gov/businesses/small/article/0,,id=231826,00.html

___________________________ 2010b. SOI Tax Stats – SOI Bulletin: Winter 2010, March 4. Available at http://www.irs.gov/taxstats/article/0,,id=219330,00.html

___________________________ 2010c. IRS Continues to Increase Oversight of Tax Return Preparers to Improve Compliance, Taxpayer Service, April 2010. Available at http://www.irs.gov/newsroom/article/0,,id=221080,00.html

___________________________ 2010d. FAQs Related to Tax Return Preparer Penalty Notices, October 12. Available at http://www.irs.gov/taxpros/article/0,,id=179707,00.html

___________________________ 2009a. IRS Launches Tax Return Preparer Review; Recommendations to Improve Compliance Expected by Year End, June 4. Available at http://www.irs.gov/newsroom/article/0,,id=209375,00.html

_________________________ 2009b. Fiscal Year 2007 Enforcement and Services Results, January 16. Available at http://www.irs.gov/newsroom/article/0,,id=177701,00.html

Journal of Accountancy (JOA) 2011. IRS Targets 1040 Schedules, Procedures in Preparer Compliance Visits. January 25, 2011. Available at http://www.journalofaccountancy.com/web/20113766

Kadous, K. and A. M. Magro. 2001. The effects of exposure to practice risk on tax professionals' judgments and recommendations. *Contemporary Accounting Research* 18 (3): 451-475.

____________, _______________, and B. C. Spilker. 2008. Do effects of client preference on accounting professionals' information search and subsequent judgments persist with high practice risk? *The Accounting Review* 83 (1): 133-156.

Kahle, J.B. and R. A. White. 2004. Tax professional decision biases: the effects of initial beliefs and client preference. *The Journal of the American Taxation Association* 26 (1): 1-29.

Kaplan, S., P. M. J. Reckers, S. West, and J. Boyd. 1988. An examination of tax reporting recommendations of professional tax preparers. *Journal of Economic Psychology* 9 (4): 427-443.

Mason, J. and L. Levy. 2001. The use of the latent constructs method in behavioral accounting research: The measurement of client advocacy. *Advances in Taxation* 13: 123-139.

McGill, G. A. 1990. The CPA's aggressive position recommendation decision: Situational, attitudinal, and personality factors. Working paper, University of Florida.

Milliron, V. C. 1988. A conceptual model of factors influencing tax preparers' aggressiveness. In *Contemporary Tax Research*, edited by Shane Moriarity and Julie H. Collins. Norman, OK: The Center for Economic and Management Research, The University of Oklahoma.

Newberry, K. J., P. M. J. Reckers, and R. W. Wyndelts. 1993. An examination of tax practitioner decisions: The role of preparer sanctions and framing effects associated with client condition. *Journal of Economic Psychology* 14 (2): 439-452.

Reckers, P. M. J., D. L. Sanders, and R. W. Wyndelts. 1991. An empirical investigation of factors influencing tax practitioner compliance. *The Journal of the American Taxation Association* 13 (2): 30-46.

Roberts, M. L. 1998. Tax accountants' judgments/decision-making research: A review and synthesis. *The Journal of the American Taxation Association* 20 (1): 78-121.

___________ and B. R. Cargile. 1994. Impartiality versus advocacy: CPAs' responses to conflict in auditing and tax situations. Working paper, University of Alabama.

Schafer, J. 2010. Discussion of the role of client advocacy in the development of tax professionals' advice. *The Journal of the American Taxation Association* 32 (1): 53-57.

Slemrod, J. 2007. Cheating ourselves: The economics of tax evasion. *The Journal of Economic Perspectives* 21 (1): 25-48.

Witte, A. D. 1983. Economic theories. In S.H. Kalish (Ed.) *Encyclopedia of crime justice*. New York: Free Press.

__________ and Woodbury, D. F. 1985. The effect of tax laws and tax administration on tax compliance: the case of the U.S. individual income tax. *National Tax Journal* March: 1-13.

LIST OF REFERENCES – ESSAY THREE

American Institute of Certified Public Accountants (AICPA). 2009. Statements on Standards for Tax Services. November 2009.

Anderson, S. and Wolfe, J. 2002. A Perspective on Audit Malpractice Claims. *Journal of Accountancy* 194 (3): 59-66.

Bamber, E. M. and V. M. Iyer. 2007. Auditors' identification with their clients and its effect on auditors' objectivity. *Auditing: A Journal of Practice & Theory* 26 (2): 1-24.

Bandy, D., L. Betancourt, and C. Kelliher. 1994. An empirical study of the objectivity of CPAs' tax work. *Advanced in Taxation* 6: 1-23.

Beattie, V., R. Brandt, and S. Fearnley. 1999. Perceptions of auditor independence: U.K. evidence. *Journal of International Accounting, Auditing, and Taxation* 8 (1): 67-107.

Bhattacharya, C.B., H. Rao, and M.A. Glynn. 1995. Understanding the bond of identification: an investigation of its correlates among art museum members. *The Journal of Marketing* 59 (4): 46-57.

Bobek, D., A. Hageman, and R. Hatfield. 2010. The role of client advocacy in the development of tax professionals' advice. *The Journal of the American Taxation Association* 32 (1): 25-51.

Cloyd, C., and B. Spilker. 1999. The influence of client preferences on tax professionals' search for judicial precedents, subsequent judgments and recommendations. *The Accounting Review* 74: 299-322.

Cuccia, A.D. 1994. The effects of increased sanctions on professional tax preparers: Integrating economic and psychological factors. *The Journal of the American Taxation Association* 16 (1): 41-66.

Cuccia, A.D. 1995. Diversity in the professional tax preparation industry and potential consequences for regulation: Linking attitudes and behavior. *Advanced in Taxation* 7: 73-98.

Cuccia, A.D., K. Hackenbrack, and M.W. Nelson. 1995. The ability of professional standards to mitigate aggressive reporting. *The Accounting Review* 70 (2): 227-248.

DeAngelo, L. 1981. Auditor size and audit quality. *Journal of Accounting and Economics* (3): 189-199.

Hansen, V.J., and R.A. White. An investigation of the impact of preparer penalty provisions on tax preparer aggressiveness. *The Journal of the American Taxation Association* 34 (1): 137-165.

Hogg, M. and D. Terry. 2000. Social identity and self-categorization processes in organizational contexts. *Academy of Management Review* 25 (1): 121-140.

Johnson, L.M. 1993. An empirical investigation of the effects of advocacy on preparers' evaluations of judicial evidence. *The Journal of the American Taxation Association* 15 (1): 1-22.

Kadous, K. and A. M. Magro. 2001. The effects of exposure to practice risk on tax professionals' judgments and recommendations. *Contemporary Accounting Research* 18 (3): 451-475.

Keune, M.B. and K.M. Johnstone. 2012. Materiality judgments and the resolution of detected misstatements: the role of managers, auditors, and audit committees. *The Accounting Review* 87 (5): 1641-1677.

Kiplinger Report. 2013. IRS Audit Red Flags: The Dirty Dozen. March 2013. http://www.kiplinger.com/article/taxes/T054-C000-S001-irs-audit-red-flags-the-dirty-dozen.html

Lowe, D.J. and K. Pany. 1995. CPA performance of consulting engagements with audit clients: effects on financial statement users' perceptions and decisions. *Auditing: A Journal of Practice & Theory* 14 (2): 35-53.

Mael, F. and B.E. Ashforth. 1992. Alumni and their alma mater: a partial test of the reformulated model of organizational identification. *Journal of Organizational Behavior* 13: 103-123.

Mason, J. and L. Levy. 2001. The use of the latent constructs method in behavioral accounting research: The measurement of client advocacy. *Advances in Taxation* 13: 123-139.

McGill, G.A. 1990. The CPA's aggressive position recommendation decision: Situational, attitudinal, and personality factors. Working paper, University of Florida.

Nelson, M.W. 2009. A model and literature review of professional skepticism in auditing. *Auditing: A Journal of Practice & Theory* 28 (2): 1-34.

Pauly, E. 2008. Raising penalty standard "more likely than not" creates conflict between tax lawyers and their clients. *Washburn Law Journal* 47: 757-783.

Reckers, P.M.J., D.L. Sanders, and R.W. Wyndelts. 1991. An empirical investigation of factors influencing tax practitioner compliance. *The Journal of the American Taxation Association* 13 (Fall): 30-46.

Reid, A. and K. Deaux. 1996. Relationship between social and personal identities: segregation or integration? *Journal of Personality and Social Psychology* 71 (6): 1084-1091.

Reynolds, J.K. and J.R. Francis. 2001. Does size matter? The influence of large clients on office-level auditor reporting decisions. *Journal of Auditing and Economics* 30: 375-400.

Roberts, M. L. 1998. Tax accountants' judgments/decision-making research: A review and synthesis. *The Journal of the American Taxation Association* 20 (1): 78-121.

Russo, T.C. 1998. Organizational and professional identification: a case of newspaper journalists. *Management Communication Quarterly* 12 (1): 72-111.

Tajfel, H. 1970. Experiments in intergroup discrimination. *Scientific American* 223 (5): 96-102.

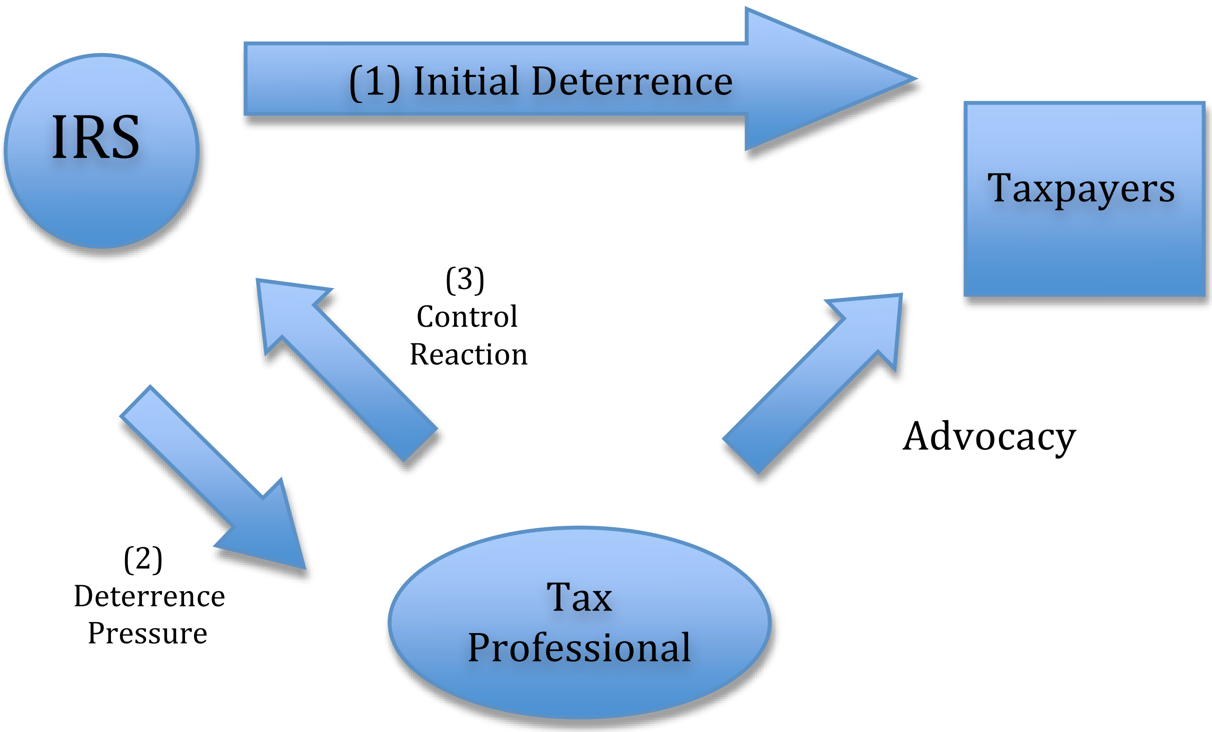
Tajfel, H. 1978. Differentiation between social groups. New York, NY: Academic Press Inc.

Turner, J. 1978. Social comparison, similarity and ingroup favoritism. In Tajfel, H. Differentiation between social groups. Academic Press, Inc., 235-250.

Underwood, R., E. Bond, and R. Baer. 2001. Building service brands via social identity: lessons from the sports marketplace. *Journal of Marketing Theory and Practice* 9 (1): 1-13.

Vermeer, B.Y. 2012. IRS Oversight, Client Risk, and Tax Professionals: Does Increased Control Deter Aggressive Decision Making? Working paper, Drexel University.

FIGURE 1
Theoretical Deterrence and Control Relationships



(1) Initial focus of Internal Revenue Service (IRS) deterrence activities on individual taxpayers to increase taxpayer compliance.
(2) Recent initiatives push deterrence initiatives down to tax professionals in efforts to increase taxpayer compliance through the services of tax professionals.
(3) These efforts create an implicit control reaction from tax professionals who are put in a position of acting in the best interest of the IRS, which is in direct conflict with the professional standard of advocacy.

FIGURE 2
Interaction of IRS Oversight and Practice Risk on Final Recommendations

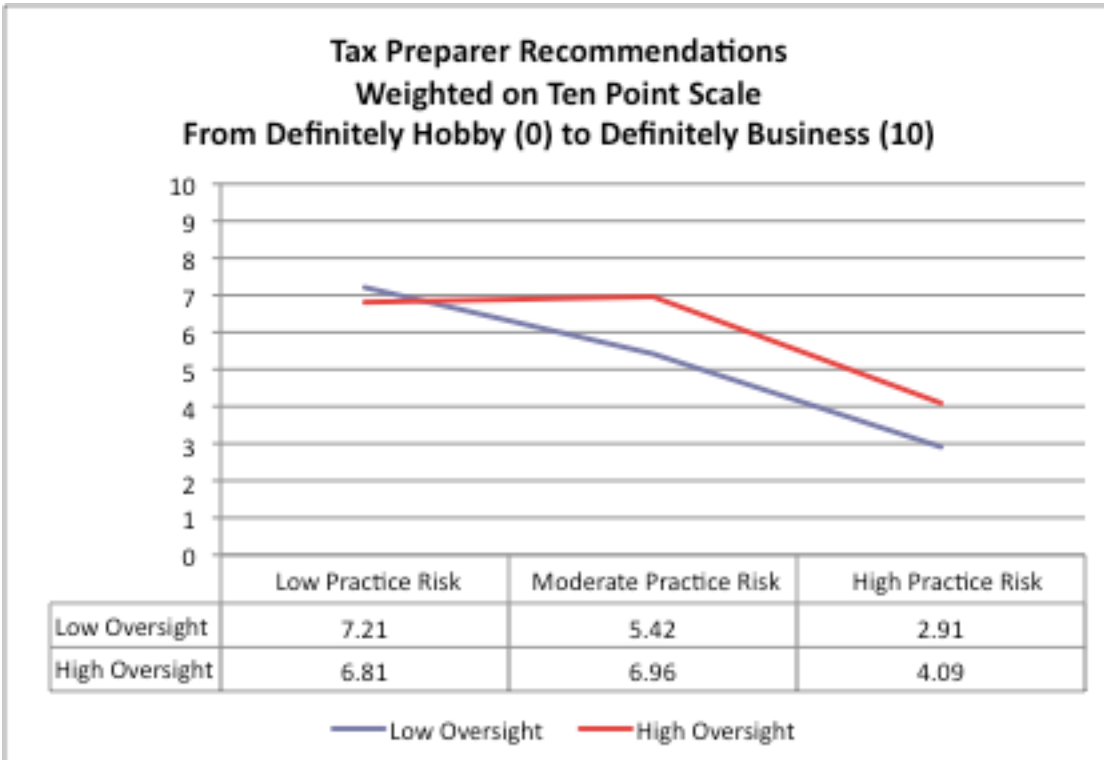
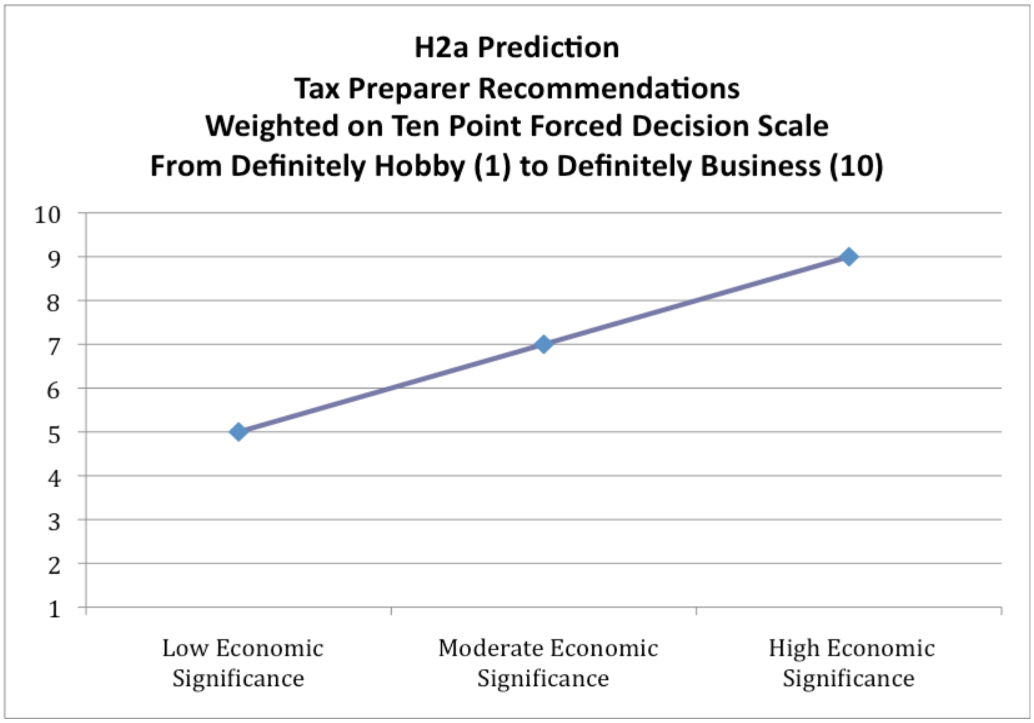


FIGURE 3
Hypothesized Effects of Economic Importance
H2a and H2b



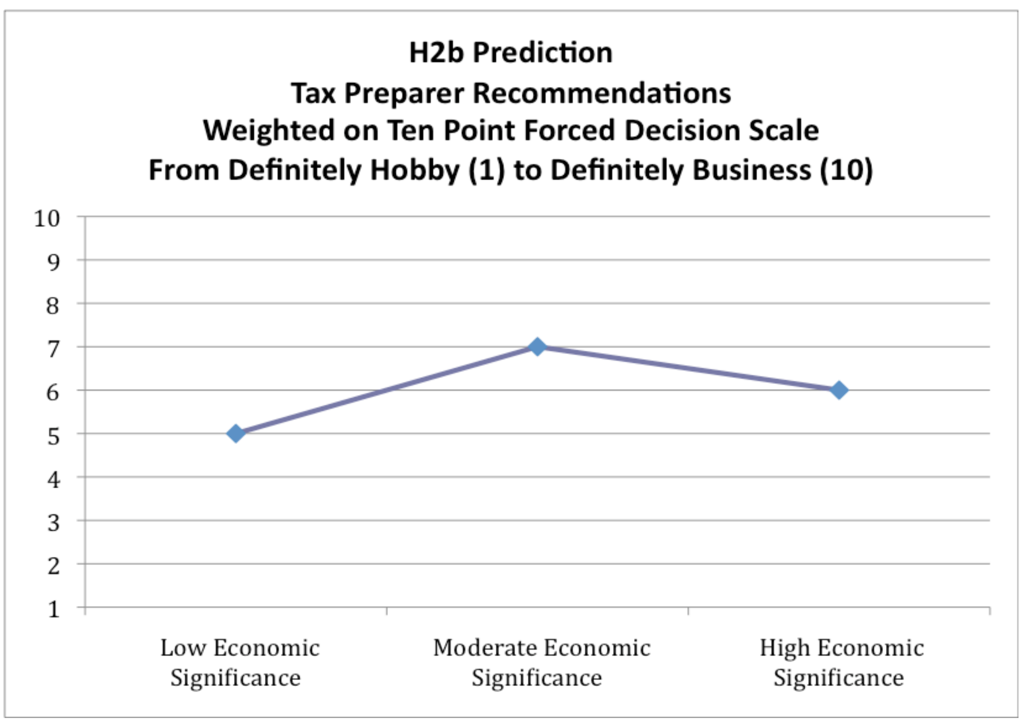


FIGURE 4
Main Effects of Economic Importance and Client Identification on Recommendations

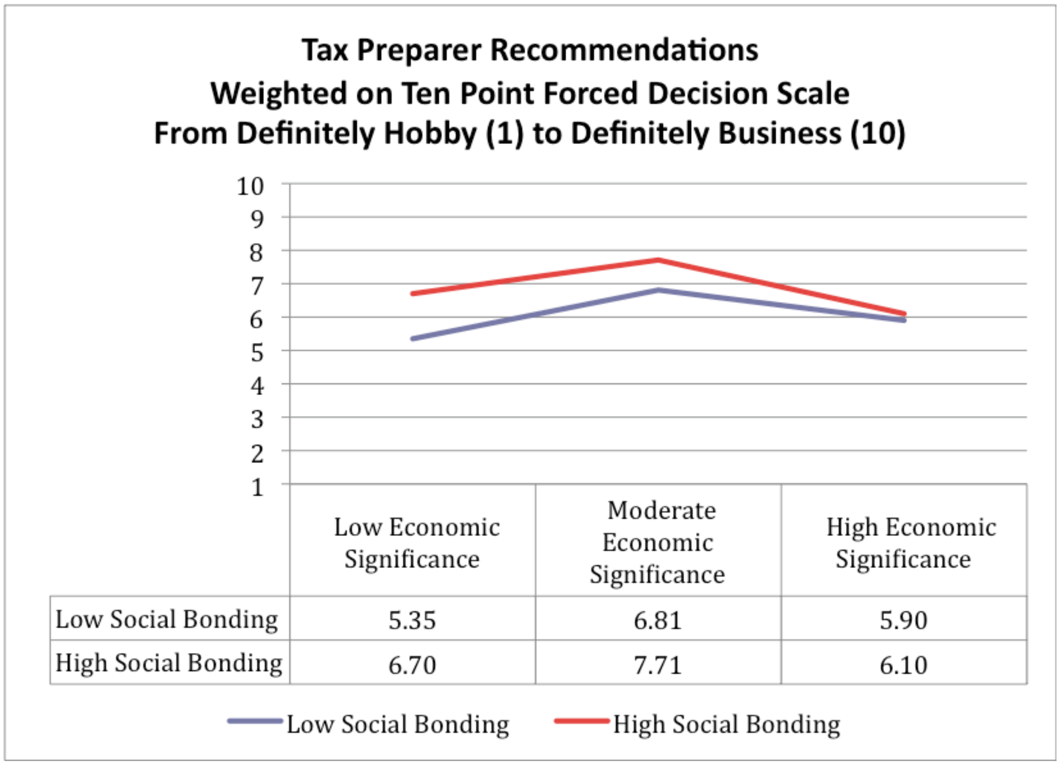


TABLE 1
Practice Risk

Level/Definition – This Study		Perceived[1] Risk	Percent[33] Similar	Level/Definition – Kadous et al. (2008)	
Low	• Have a history of responding timely to requests for information and documentation • Usually provide complete records when requested • Have no history of prior IRS audit • Have no history of engaging their tax practitioner or others in litigation.	1.93	64.20%		
				Low	• Responds promptly to requests for information or documentation • Successfully defended positions during prior audits • Has no history of engaging his prior tax practitioner and others in litigation
Moderate	• Have a history of responding slowly or failing to respond to requests for information or documentation • Usually provide incomplete records when requested • Have been unable to defend tax positions during prior IRS audit • Have no history of engaging their tax practitioner or others in litigation.	4.94	31.33%		
High	• Have a history of responding slowly or failing to respond to requests for information or documentation • Have been unable to defend tax positions during prior IRS audits • Have a history of engaging their prior tax practitioner and others in litigation	5.82	6.04%	High	• Responds slowly or fails to respond to requests for information or documentation • Has been unable to successfully defend positions during prior audits • Has a history of engaging his prior tax practitioner and others in litigation

[1] In this study, 144 tax professionals rated the perceived risk level of the low/moderate/high practice risk taxpayer profiles as 1.93/4.94/5.82 on a scale ranging from lowest (1) to highest (7) risk. They also noted the percent of similar clients of the low/moderate/high practice risk profiles as 64.20 percent/31.33 percent/6.04 percent on a 100 percent scale.

TABLE 2
Ambiguous Decision Scenario - Recommendations

Panel A: Mean (Standard Deviation)[a]

Practice Risk

IRS Oversight	Low[d]	Moderate[e]	High[f]	Overall
Low (General)	1 7.21[c] (2.64) n= 24	2 5.42 (2.57) n= 24	3 2.91 (1.50) n= 23	5.21 (2.88) n= 71
High (Imminent)	4 6.81[c] (2.42) n= 26	5 6.96 (2.52) n= 25	6 4.09 (1.77) n= 22	6.04 (2.59) n= 73
Overall	7.00 (2.51) n= 50	6.20 (2.64) n= 49	3.49 (1.73) n= 45	

Panel B: ANOVA Results

	F	p-value[b]
Model	13.79	<0.001
Experimental Variables		
IRS Oversight	4.08	0.045
Practice Risk	29.80	<0.001
Interaction		
IRS Oversight x Practice Risk	2.50	0.086

Panel C: Contrast Tests Between Groups – IRS Oversight

Comparison	t-stat	p-value
Low versus high IRS oversight at:		
Low Practice Risk (cells 1 versus 4)	.314	.578
Moderate Practice Risk (cells 2 versus 5)	4.48	.039
High Practice Risk (cells 3 versus 6)	5.81	.020

TABLE 2 (continued)
Ambiguous Decision Scenario - Recommendations

Panel D: Contrast Tests Between Groups – Practice Risk

Comparison	t-stat	p-value
Low versus moderate practice risk/Low IRS oversight (cells 1 versus 2)	5.683	.021
Moderate versus high practice risk/Low IRS oversight (cells 2 versus 3)	16.428	.000
Low versus moderate practice risk/High IRS oversight (cells 4 versus 5)	.048	.827
Moderate versus high practice risk/High IRS oversight (cells 5 versus 6)	19.814	.000

[a] Participants indicated their recommendation using a ten-point scale numbered from 1 (“Definitely Hobby”) to 10 (“Definitely Business”)
[b] p-values are based on two-tailed tests.
[c] These results are consistent with the results in Cloyd and Spilker (1999), interpreting their general client profile as a low practice risk profile.
[d] The low practice risk profile is a new practice risk profile, defined by removing the incidence of prior IRS audit from the definition used in prior research.
[e] The moderate practice risk profile is a new practice risk profile, removing the history of engaging their tax practitioner and others in litigation from the high practice risk profile.
[f] The high practice risk profile is a replication of the high practice risk profile in Kadous et al. (2008).

TABLE 3
Total Client-Specific Advocacy Scores

Panel A: Mean (Standard Deviation)[a]

IRS Oversight	Practice Risk: Low	Practice Risk: Moderate	Practice Risk: High	Overall
Low (General)	43.25 (6.85) n= 24	42.46 (7.74) n= 24	33.39 (10.33) n= 23	39.79 (9.42) n= 71
High (Imminent)	45.92 (7.47) n= 26	46.58 (7.38) n= 25	37.48 (6.37) n= 22	43.60 (8.11) n= 73
Overall	44.64 (7.23) n= 50	44.56 (7.76) n= 49	35.39 (8.78) n= 45	

Panel B: ANOVA Results

	F	p-value
Model	10.27	<0.001
Experimental Variables		
IRS Oversight	7.80	0.006
Practice Risk	21.22	<0.001
Interaction		
IRS Oversight x Practice Risk	0.14	0.871

[a] Participants responded to 9 questions (Mason and Levy (2001) Advocacy Scale) using a seven point Likert-type scale on each question, ranging from strongly disagree to strongly agree. The advocacy scores for each of the nine items were then added together to find the total advocacy score (63 point maximum).

TABLE 4
Non-ambiguous Decision Scenario - Recommendations

Panel A: Mean (Standard Deviation)[a]

IRS Oversight	Practice Risk: Low	Moderate	High	Overall
Low (General)	97.92 (5.09) n= 24	95.00 (8.85) n= 24	89.57 (12.96) n= 23	94.23 (9.95) n= 71
High (Imminent)	91.54 (11.20) n= 26	97.20 (6.78) n= 25	87.95 (9.59) n= 22	92.40 (10.00) n= 73
Overall	94.60 (9.30) n= 50	96.12 (7.86) n= 49	88.78 (11.34) n= 45	

Panel B: ANOVA Results

	F	p-value[b]
Model	4.48	0.001
Experimental Variables		
IRS Oversight	1.50	0.222
Practice Risk	7.95	0.001
Interaction		
IRS Oversight x Practice Risk	2.57	0.080

[a] Participants indicated their recommendation using a one hundred percentage point scale, ranging from 0 percent (no allowable business use deduction) to 100 percent (a fully deductible business use deduction).
[b] p-values are based on two-tailed tests.

TABLE 5
Description of Sample
(n = 133)

Characteristic	Mean	Percent
Tax Experience, in months	85.20 (7.10 years)	
Gender – Percentage of male/female subjects		52.6%/47.4%
Employed by national firm		12.1%
Employed by regional firm		52.3%
Employed by local firm		35.6%
Licensed CPA		84.2%
Percentage with advanced degree		48.1%
Have the authority to recommend tax positions to clients		68.4%
Decision Familiarity*		86.6%

* Participate in decisions involving business/hobby treatment for current tax clients

TABLE 6
Recommendations

Panel A: Mean (Standard Deviation)[a]

Client Identification	Economic Importance: Low (<1%)	Moderate (6%)	High (12%)	Overall
Low	1 5.05 (3.01) n= 22	2 6.57 (1.67) n= 23	3 5.90 (2.34) n= 21	5.85 (2.44) n= 66
High	4 6.83 (2.80) n= 24	5 7.82 (2.10) n= 22	6 6.10 (1.86) n= 21	6.93 (2.38) n= 67
Overall	5.98 (3.01) n= 46	7.18 (1.98) n= 45	6.00 (2.09) n= 42	

Panel B: ANCOVA Results[b]

	F	p-value[c]
Model	7.09	<0.001
Experimental Variables		
Economic Importance	6.24	0.003
Client Identification	8.14	0.005
Interaction		
Economic Importance x Client Identification	0.89	0.414

Panel C: Pairwise Comparisons on Three Level Variables

Comparison	p-value
Economic Importance:	
Low versus Moderate Economic Importance	0.002
Moderate versus High Economic Importance	0.003
Low versus High Economic Importance	0.984

TABLE 6 (continued)
Recommendations

[a] Participants indicated their recommendation using a ten-point scale numbered from 1 ("Definitely Hobby") to 10 ("Definitely Business"); overall, 35.8 percent indicated hobby treatment and 64.2 percent indicated business treatment.
[b] Gender and decision familiarity are included in the ANCOVA model because they have been found to have an impact on decision-making in prior research (McGill 1990; Reckers at al. 1991; Roberts 1998; Hansen and White 2012) and are significant variables in the model. Although these covariates contribute to the overall power of the model, their inclusion does not substantially alter the main effects of the study (ANOVA model without gender and decision familiarity as covariates, $F = 3.371$, $p = 0.007$). The mean recommendation for males is 7.16 while the mean recommendation for females is 5.54 ($t = 3.981$, $p < 0.001$). This result on gender is consistent with prior research indicating that males are less risk averse than females (McGill 1990; Hansen and White 2012). The mean for decision familiarity (decision experience) is 3.42 on a scale of 1 to 7, with 1 indicating "never" and 7 indicating "frequent" participation, with 86.6 percent of the participants indicating they participate in business/hobby decisions for current tax clients.[1] Thus, participants are well suited for the experimental task.
[c] p-values are based on two-tailed tests

[1] Task specific familiarity has been found to be a significant measure impacting differences in judgment and decision-making (Reckers et al. 1991; Roberts 1998).

APPENDIX A
INSTRUMENT - ESSAY TWO

PART A

Thank you for your assistance with this study.

By participating in this study, you are helping me complete the requirements of my doctoral program. In addition, my research is intended to help the professional tax community and, when published, could have a potentially beneficial impact on future policy considerations and on the work of tax professionals.

All individual information and responses will be kept completely confidential. Your responses are completely anonymous and no identifiers are used to link responses to individual participants.

Please read all directions carefully and answer all questions to the best of your ability. Please do not discuss the contents of your materials with any other individuals until all materials have been completed and turned in. If you have questions, please notify one of the administrators of this study.

After you have completed the materials, please turn them in. If you would like to participate in the raffle, please get a raffle ticket when you turn in your materials. Once all participants have completed the materials, we will award cash prizes.

Again, thank you for your time and assistance!

Sincerely,

Beth Vermeer, PhD Student, Drexel University
AICPA Accounting Doctoral Scholar

Faculty Advisors: Anthony Curatola, PhD
Bernhard Reichert, PhD

Treatment 1: Low/General Oversight

Shortly, I will ask you to make two tax reporting decisions for two different clients. When making your decisions for each client, please apply the following information as part of each decision.

In 2010, the IRS began implementation of a comprehensive plan to provide better control and oversight of professional tax preparers. As part of this process, in January 2010, the IRS sent letters to over 10,000 paid tax preparers/offices stating that the IRS plans to visit a number of tax preparers' offices.

The new IRS initiatives are aimed at directly monitoring and overseeing tax professionals. If selected for a visit under these initiatives, the IRS requests and reviews numerous client tax files prepared by the selected preparer(s) during a visit to the preparer's offices.

Doug Shulman, Commissioner of the IRS, stated that the goal of these initiatives is to develop a "comprehensive set of recommendations to help the Internal Revenue Service better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers" (IRS 2009).

During the initial phase of these new oversight measures, the IRS will continue to work closely with the Department of Justice to pursue civil or criminal action as appropriate. During 2010, these new IRS initiatives lead to 56 indictments, 25 convictions, and 21 civil injunctions. (IRS 2010)

In November 2010, as part of the second year initiatives, the IRS again sent letters to over 10,000 paid tax preparers/offices and is planning to visit a portion of the notified preparers/offices during 2011.

<u>You/your firm did not receive a letter from the IRS in either 2010 or 2011 and will not be visited as part of these new initiatives during 2010 or 2011.</u>

Please answer the following question by circling your answer choice:

1) As part of this study, please circle whether the information above indicates that you or your firm has been selected for a visit from the IRS?

YES NO

Treatment 2: High/Imminent Oversight

Shortly, I will ask you to make two tax reporting decisions for two different clients. When making your decisions for each client, please apply the following information as part of each decision.

In 2010, the IRS began implementation of a comprehensive plan to provide better control and oversight of professional tax preparers. As part of this process, in January 2010, the IRS sent letters to over 10,000 paid tax preparers/offices stating that the IRS plans to visit a number of tax preparers' offices.

The new IRS initiatives are aimed at directly monitoring and overseeing tax professionals. If selected for a visit under these initiatives, the IRS requests and reviews numerous client tax files prepared by the selected preparer(s) during a visit to the preparer's offices.

Doug Shulman, Commissioner of the IRS, stated that the goal of these initiatives is to develop a "comprehensive set of recommendations to help the Internal Revenue Service better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers" (IRS 2009).

During the initial phase of these new oversight measures, the IRS will continue to work closely with the Department of Justice to pursue civil or criminal action as appropriate. During 2010, these new IRS initiatives lead to 56 indictments, 25 convictions, and 21 civil injunctions. (IRS 2010)

In November 2010, as part of the second year initiatives, the IRS again sent letters to over 10,000 paid tax preparers/offices and is planning to visit a portion of the notified preparers/offices during 2011.

<u>You/your firm received a letter from the IRS in November 2010 AND your firm has recently been notified that it has been selected for an IRS visit during September 2011.</u>

Please answer the following question by circling your answer choice:

1) As part of this study, please circle whether the information above indicates that you or your firm has been selected for a visit from the IRS?

YES NO

All treatments:

PART A

CLIENT 1

Please read the following information and answer the questions that follow for Client #1.

Treatment 1: Low Risk

John and Joanne Lewis are your tax clients. They are high-income taxpayers. John is the president of a regional restaurant group and Joanne is a computer analyst. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

Treatment 2: High Risk

John and Joanne Lewis are your tax clients. They are high-income taxpayers. John is the president of a regional restaurant group and Joanne is a computer analyst. John and Joanne have been clients of your firm for three years. They have a history of responding slowly or failing to respond to requests for information or documentation, usually provide incomplete records when requested, have been unable to defend tax positions during prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

Treatment 3: Severe Risk (High Risk definition used in prior research)

John and Joanne Lewis are your tax clients. They are high-income taxpayers. John is the president of a regional restaurant group and Joanne is a computer analyst. John and Joanne have been clients of your firm for three years. They have a history of responding slowly or failing to respond to requests for information or documentation, have been unable to defend tax positions during prior IRS audits, and have a history of engaging their prior tax practitioner and others in litigation.

Given for all Treatments:

Two years ago, Joanne decided to pursue her lifelong dream of becoming a writer. During the past year, in addition to her job as a computer analyst, she has attended several writing workshops and conferences and has written 35 pages (4 chapters) of her first novel. Joanne has submitted her novel chapters to multiple publishing agents, but none have been interested in signing her to a contract yet. She was excited to win a $450 prize for “novel ideas” at a conference she attended in Las Vegas in December. This is the only income received to date in connection with her writing activities. John and Joanne want to make Joanne’s writing pursuits a business, which then allows them to deduct $33,000 of expenses related to travel, conference fees, and supplies incurred in connection with Joanne’s writing activities over the past year (Schedule C).

Treasury Regulation §1.183-2 excerpts are provided in Appendix A to help you in your decision. You should assume that there are no other applicable tax cases, or regulatory authority, that specifically deal with writing activities and business versus hobby loss rules in making your decisions.

After carefully reading the above materials and, if needed, referencing the Treasury Regulation excerpts provided in Appendix A, please answer the following questions pertaining to Client #1. Please keep in mind that your office has/has not been selected by the IRS to receive a visit.

1) John and Joanne want to treat the writing activities as a business. Please circle the number, which represents your most likely **recommended** position? (i.e., What would you **recommend** that the taxpayers claim on their tax return?)

Hobby Business

|---------|---------|---------|---------|----- | -----|---------|---------|---------|---------|

1 2 3 4 5 6 7 8 9 10

Definitely Hobby Definitely Business

2) How strongly do you feel about your recommendation? Please circle the percentage, which **best reflects** your confidence level with your recommendation.

|-----------------|-----------------|-----------------|-----------------|-----------------|

0% 20% 40% 60% 80% 100%

3) John and Joanne want to treat the writing activities as a business. Please circle the number, which represents your most likely **allowed** position? (i.e., What would you **allow** the taxpayers to claim on their tax return?)

Hobby Business

|---------|---------|---------|---------|----- | -----|---------|---------|---------|---------|

1 2 3 4 5 6 7 8 9 10

Definitely Hobby Definitely Business

4) Please circle the number that **best reflects** the level of risk you associate with your overall decision. Please rate the level of risk you associate with the **overall decision.**

1 2 3 4 5 6 7

Not risky at all Extremely risky

5) Please circle the number that **best reflects** the level of risk you associate with **this client**. Please consider the client profile details only (in regard to their cooperation, audit history, litigation history, and overall risk level), prior to and excluding the hobby/business decision.

1 2 3 4 5 6 7

Not risky at all ... Extremely risky

6) Please circle the percentage of your **current** tax clients that are similar (in regard to their cooperation, audit history, litigation history, and overall risk level) to this client?

|------------------|------------------|------------------|------------------|------------------|

0% 20% 40% 60% 80% 100%

7) How risk seeking/risk averse do you think this client is? Please circle your perception of this client's risk acceptance level.

1 2 3 4 5 6 7

Client is risk averse (not willing to take risks) ... Client is risk seeking (willing to take significant risks)

8) Please circle the number, on each scale, that best reflects the importance of the following issues and the relative impact of each of the following items on your tax reporting decisions:

a) Riskiness of this client profile

1 2 3 4 5 6 7

Not important ... Extremely important

b) IRS oversight risks to me or my firm

1 2 3 4 5 6 7

Not important ... Extremely important

c) IRS oversight risks to my entire client base

1 2 3 4 5 6 7

Not important ... Extremely important

d) Risk of IRS audit of this client

1 2 3 4 5 6 7

Not important — Extremely important

e) My relationship with this client

1 2 3 4 5 6 7

Not important — Extremely important

9) Please circle the number, on each scale, that **best reflects** your beliefs.

a) In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that John and Joanne are entitled to take the most favorable tax treatment.

1 2 3 4 5 6 7

Strongly disagree — Strongly agree

b) Generally speaking, my loyalties are first to the tax system, then to John and Joanne.

1 2 3 4 5 6 7

Strongly disagree — Strongly agree

c) I feel I should apply ambiguous tax law to John and Joanne's benefit.

1 2 3 4 5 6 7

Strongly disagree — Strongly agree

d) When examining a tax return, I tend to point out to John and Joanne reasonable positions they could have taken which would have contributed to minimizing their tax liability.

1 2 3 4 5 6 7

Strongly disagree — Strongly agree

e) I believe it is important that I encourage John and Joanne to pay the least amount of taxes possible.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

f) I always interpret unclear/ambiguous laws in favor of John and Joanne.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

g) It is important to use trends in the law by trying to establish a pattern of more favorable treatment for John and Joanne and then extending this pattern to the taxpayer's position.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

h) Where no judicial authority exists with respect to an issue, I feel that John and Joanne are entitled to take the most favorable tax treatment.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

i) John and Joanne have the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

This is the end of Part A!

Please raise your hand so we can collect Part A before you move on to complete Part B.

PART B

CLIENT 2

Please read the following information and answer the questions that follow for Client #2.

Treatment 1: Low Risk

Jim and Sue Connor are your tax clients. They are high-income taxpayers. Jim owns a construction company and Sue is a doctor. Jim and Sue have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

Treatment 2: High Risk

Jim and Sue Connor are your tax clients. They are high-income taxpayers. Jim owns a construction company and Sue is a doctor. Jim and Sue have been clients of your firm for three years. They have a history of responding slowly or failing to respond to requests for information or documentation, usually provide incomplete records when requested, have been unable to defend tax positions during prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

Treatment 3: Severe Risk (High Risk definition used in prior research)

Jim and Sue Connor are your tax clients. They are high-income taxpayers. Jim owns a construction company and Sue is a doctor. Jim and Sue have been clients of your firm for three years. They have a history of responding slowly or failing to respond to requests for information or documentation, have been unable to defend tax positions during prior IRS audits, and have a history of engaging their prior tax practitioner and others in litigation.

Given for all Treatments:

Jim Connor owns a construction company and has multiple construction sites within a 60-mile radius of his construction office, which is attached to his personal residence. Jim purchased a 2011 Mercedes-Benz ML550 SUV (hereafter termed SUV) for $58,000 to use full time in his business. Jim states that he uses the SUV entirely for business purposes, parks the SUV at his home office at the end of each workday, and maintains a second car for personal use. He has detailed mileage logs substantiating his business use deduction of the SUV. Based on the information provided, Jim wants to claim 100% business use on the SUV and deduct the maximum allowable expenses on his Schedule C.

An excerpt from IRS Tax Topic 510 is provided in Appendix B to help you in your decision. You should assume that there are no other applicable tax cases, or regulatory authority, that specifically deal with business use of an automobile in making your decisions.

After carefully reading the above materials and, if necessary, referencing Tax Topic 510 from the IRS website in Appendix B, please answer the following questions pertaining to Client #2. Please keep in mind that your office has/has not been selected by the IRS to receive a visit.

1) Jim and Sue want to claim 100% business use of the SUV. Please circle the business use percentage you would most likely **recommend**? (i.e., What percentage would you **recommend** that the taxpayers claim on their tax return?)

Business Use Percentage Recommended

|---------|---------|---------|---------|----------|---------|---------|---------|---------|---------|
0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

2) How strongly do you feel about your recommendation? Please circle the percentage, which **best reflects** your confidence level with your recommendation.

|-----------------|-----------------|-----------------|-----------------|-----------------|
0% 20% 40% 60% 80% 100%

3) Jim and Sue want to claim 100% business use of the SUV. Please circle the business use percentage you would most likely **allow**? (i.e., What percentage would you **allow** the taxpayers to claim on their tax return?)

Business Use Percentage Allowed

|---------|---------|---------|---------|----------|---------|---------|---------|---------|---------|
0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

4) Please circle the number that **best reflects** the level of risk you associate with your overall decision. Please rate the level of risk you associate with the **overall decision.**

1 2 3 4 5 6 7

Not risky at all Extremely risky

5) Please circle the number that **best reflects** the level of risk you associate with **this client**. Please consider the client profile details only (in regard to their cooperation, audit history, litigation history, and overall risk level), prior to and excluding the business use of the SUV decision.

1 2 3 4 5 6 7

Not risky at all Extremely risky

6) Please circle the percentage of your **current** tax clients that are similar (in regard to their cooperation, audit history, litigation history, and overall risk level) to this client?

|------------------|------------------|------------------|------------------|------------------|
0% 20% 40% 60% 80% 100%

7) How risk seeking/risk averse do you think this client is? Please circle your perception of this client's risk acceptance level.

1 2 3 4 5 6 7

Client is risk averse (not willing to take risks) — Client is risk seeking (willing to take significant risks)

8) Please circle the number, on each scale, that best reflects the importance of the following issues and the relative impact of each of the following items on your tax reporting decisions:

a) Riskiness of this client profile

1 2 3 4 5 6 7

Not important — Extremely important

b) IRS oversight risks to me or my firm

1 2 3 4 5 6 7

Not important — Extremely important

c) IRS oversight risks to my entire client base

1 2 3 4 5 6 7

Not important — Extremely important

d) Risk of IRS audit of this client

1 2 3 4 5 6 7

Not important — Extremely important

e) My relationship with this client

1 2 3 4 5 6 7

Not important — Extremely important

9) Please circle the number, on each scale, that **best reflects** your beliefs.

a) In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that Jim and Sue are entitled to take the most favorable tax treatment.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

b) Generally speaking, my loyalties are first to the tax system, then to Jim and Sue.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

c) I feel I should apply ambiguous tax law to Jim and Sue's benefit.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

d) When examining a tax return, I tend to point out to Jim and Sue reasonable positions they could have taken which would have contributed to minimizing their tax liability.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

e) I believe it is important that I encourage Jim and Sue to pay the least amount of taxes possible.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

f) I always interpret unclear/ambiguous laws in favor of Jim and Sue.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

g) It is important to use trends in the law by trying to establish a pattern of more favorable treatment for Jim and Sue and then extending this pattern to the taxpayer's position.

1	2	3	4	5	6	7
Strongly disagree						Strongly agree

h) Where no judicial authority exists with respect to an issue, I feel that Jim and Sue are entitled to take the most favorable tax treatment.

1	2	3	4	5	6	7
Strongly disagree						Strongly agree

i) Jim and Sue have the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.

1	2	3	4	5	6	7
Strongly disagree						Strongly agree

Once you have completed these questions for Client #2, please do not go back and change your answers.

As mentioned earlier, the new IRS initiatives are aimed at directly monitoring and overseeing tax professionals. If selected for a visit under these initiatives, the IRS requests and reviews numerous client tax files prepared by the selected preparer(s) during a visit to the preparer's offices.

Doug Shulman, Commissioner of the IRS, stated that the goal of these initiatives is to develop a "comprehensive set of recommendations to help the Internal Revenue Service better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers" (IRS 2009). During 2010, these new oversight initiatives led to approximately 5,000 IRS field visits to tax return preparers, leading to 56 indictments, 25 convictions, and 21 civil injunctions. (IRS 2010)

Please answer the following questions regarding your thoughts about the new IRS initiatives to provide direct monitoring and oversight of tax professionals.

1) Please circle the number that **best reflects** your belief about the fairness of the IRS office visits as a method to increase monitoring and oversight of tax professionals.

1	2	3	4	5	6	7
Completely unfair						Entirely fair

2) Please circle the number that **best reflects** your perceived **increase** in risk level (risk of an increase in IRS audits of your clients, preparer penalties, civil/criminal claims) as a result of the IRS' increased monitoring and oversight of tax professionals.

1	2	3	4	5	6	7
No increase in risk level						Extreme increase in risk level

Professionals:

Please answer the following demographic questions. Your answers will help me understand your decisions regarding Client #1 and Client #2 and are important.

1) Please indicate if you are a CPA. Yes No

2) Please indicate the number of years of professional public accounting experience you have ***as a tax professional/preparer***? ____________years

3) Please indicate your current job position/title? ___________________________________

4) How would you best characterize the type of firm you work in? Please circle one choice.

Big 4 International National Regional Local Industry

5) Please circle your highest level of education completed? Bachelor Master/MBA JD/PHD

6) Please circle your current age bracket.

Under 30 31-35 36-40 41-45 46-50 51-55 56-60 61-65 66-70 Over 70

7) Please circle your gender. Female Male

8) Please circle the number that best reflects your general willingness to take risks.

1 2 3 4 5 6 7

I am not willing to take any risks — I am willing to take a lot of risks

You have successfully completed the experiment! Thank you!!

Please bring your completed materials to the front of the room where you will receive your raffle ticket. We will conduct the raffle shortly!

Appendix A – Client #1

Treasury Regulation §1.183-2 excerpts:

Sec. 1.183-2

(b) *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* The term profit encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183–1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

Appendix B – Client #2

From http://www.irs.gov/taxtopics/tc510.html:

Topic 510 - Business Use of Car (excerpts)

If you use your car in your job or business and you use it only for that purpose, you may deduct its entire cost of operation (subject to limits discussed later). However, if you use the car for both business and personal purposes, you may deduct only the cost of its business use.

You can generally figure the amount of your deductible car expense using one of two methods: the standard mileage rate method or the actual expense method. If you qualify to use both methods, before choosing a method, you may want to figure your deduction both ways to see which gives you a larger deduction. Please refer to Publication 463, Travel, Entertainment, Gift and Car Expenses, for the current standard mileage rate. If you use the standard mileage rate, you can add to your deduction any parking fees and tolls incurred for business purposes.

To use the actual expense method, you must determine what it actually costs to operate the car for the portion of the overall use of the car that is business use. Include gas, oil, repairs, tires, insurance, registration fees, licenses, and depreciation (or lease payments) attributable to the portion of the total miles driven that are business miles.

Other car expenses for parking fees and tolls attributable to business use are separately deductible, whether you use the standard mileage rate or actual expenses.

The law requires that you substantiate your expenses by adequate records or by sufficient evidence to support your own statement. For further information on record keeping, refer to Topic 305

APPENDIX B
INSTRUMENT - ESSAY THREE

Thank you for your assistance with this study!

This project is helping me complete the requirements of my doctoral program. In addition, my research is intended to help the professional tax community and, when published, could have a potentially beneficial impact on the work of tax professionals.

The success of this project depends on your use of professional judgment and your thoughtful and complete responses to all questions. Please read all directions carefully and answer all questions to the best of your ability. Please do not discuss the contents of your materials with any other individuals until all materials have been completed and turned in. If you have questions, please notify one of the administrators of this study.

Please know that all of your individual information and responses will be kept completely confidential. Your responses are completely anonymous and neither individual participants nor your firms will be identified.

Again, thank you for your time and assistance!

Sincerely,

Beth Vermeer, PhD Candidate, Drexel University
AICPA Accounting Doctoral Scholar

Faculty Advisor: Anthony Curatola, PhD

DIRECTIONS

You will be asked to make a recommendation for a hypothetical tax client and then answer informational questions helpful to our study. We will provide you with basic client information, details of the tax issue, and applicable Treasury regulations for reference.

****PLEASE PROCEED TO THE NEXT PAGE AFTER READING THE DIRECTIONS****

THE CLIENT: JOHN AND JOANNE LEWIS

Treatment 1: Low Economic Bond/Weak Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent less than one percent (less than 1%) of your firm's annual revenues. You receive all your information about these clients through the partner on this engagement and, as such, you do not have personal contact with the taxpayers.

Treatment 2: Medium Economic Bond/Weak Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent six percent (6%) of your firm's revenues. You receive all your information about these clients through the partner on this engagement and, as such, you do not have personal contact with the taxpayers.

Treatment 3: High Economic Bond/Weak Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent twelve percent (12%) of your firm's revenues. You receive all your information about these clients through the partner on this engagement and, as such, you do not have personal contact with the taxpayers.

Treatment 4: Low Economic Bond/Strong Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent less than one percent (less than 1%) of your firm's annual revenues. Joanne has been your pharmacist for the past seven years and when John and Joanne were selecting a new tax preparer, you brought them in as clients of the firm you currently work for. As such, you meet individually with the taxpayers each year, serve as their primary point of contact, and you have established a friendly social relationship with John and Joanne.

Treatment 5: Medium Economic Bond/Strong Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent six percent (6%) of your firm's annual revenues. Joanne has been your pharmacist for the past seven years and when John and Joanne were selecting a new tax preparer, you brought them in as clients of the firm you currently work for. As such, you meet individually with the taxpayers each year, serve as their primary point of contact, and you have established a friendly social relationship with John and Joanne.

Treatment 6: High Economic Bond/Strong Social Identity

John and Joanne Lewis are your tax clients. John is the president and owner of a successful restaurant group and Joanne is a pharmacist. John and Joanne have been clients of your firm for three years. They have a history of responding timely to requests for information and documentation, usually provide complete records when requested, have no history of prior IRS audit, and have no history of engaging their tax practitioner or others in litigation.

John and Joanne's total fees, including audit and tax fees for the restaurant group, represent twelve percent (12%) of your firm's annual revenues. Joanne has been your pharmacist for the past seven years and when John and Joanne were selecting a new tax preparer, you brought them in as clients of the firm you currently work for. As such, you meet individually with the taxpayers each year, serve as their primary point of contact, and you have established a friendly social relationship with John and Joanne.

Given for all Treatments:

Joanne studied music in college before deciding to become a pharmacist. She has continued to play piano and write songs over the years. Two years ago, Joanne decided to pursue her lifelong dream of becoming a songwriter. During 2011, in addition to her job as a pharmacist, she attended several music conventions, met with music producers of three record labels, and mailed demo recordings of her songs to various contacts in the music industry. During 2011, Joanne agreed to allow a potentially promising vocal student to record one of her songs with exclusive rights to the song for 18 months. To date, she has received a $500 fee for exclusive use of the song, but has not received any royalties for the song. This is the only income received to date in connection with her songwriting activities. John and Joanne want to make Joanne's songwriting pursuits a business, which then allows them to deduct $31,000 of expenses related to travel, recording and production costs, and supplies incurred in connection with Joanne's songwriting activities over the past year (Schedule C).

Treasury Regulation §1.183-2 excerpts are provided in Appendix A to help you in your decision. You should assume that there are no other applicable tax cases, or regulatory authority, that specifically deal with songwriting activities and business versus hobby loss rules in making your decisions.

After carefully reading the above materials and referencing the Treasury Regulation excerpts provided in Appendix A, please answer the following questions pertaining to this client.

1) John and Joanne want to treat the songwriting activities as a business. Based on the information provided and the Treasury regulation excerpts in Appendix A, would you recommend hobby or business treatment for Joanne's songwriting activities? (Please circle the number that best applies.)

Hobby Business

|---------|---------|---------|---------|----- | -----|---------|---------|---------|---------|

1 2 3 4 5 6 7 8 9 10

Definitely Hobby Definitely Business

2) Please indicate how confident you are in your recommendation of hobby or business treatment. (Please circle the percentage that represents your level of confidence.)

|-----------------|-----------------|-----------------|-----------------|-----------------|

0% 20% 40% 60% 80% 100%

Not at all Confident Completely Confident

3) To what extent would you feel pressure from the client to accept John and Joanne's preferred business treatment of the songwriting activities?

1 2 3 4 5 6 7

Very low Pressure | Average Pressure | Very high Pressure

4) To what extent would you feel pressure from your firm to accept John and Joanne's preferred business treatment of the songwriting activities?

1 2 3 4 5 6 7

Very low Pressure | Average Pressure | Very high Pressure

5) Would this client represent an economically important client for your firm?

1 2 3 4 5 6 7

Not economically important | Extremely economically important

6) Comparing this hypothetical client to your actual tax clients, would you be more likely to feel a strong or weak relationship with this client?

1 2 3 4 5 6 7

Weak relationship | Strong relationship

7) Please circle the percentage of your current individual taxpayer client base that this client represents. (i.e. How similar is this client to your current individual tax clients?)

|------------------|------------------|------------------|------------------|------------------|

0% 20% 40% 60% 80% 100%

Not similar | Extremely similar

8) How often have you participated in a decision involving business or hobby treatment for a tax client?

1 2 3 4 5 6 7

Never | Frequently

9) Please rate the importance of this type of client to your current firm.

1 2 3 4 5

Not at all Very

Not at all Important — Very Important

10) a) When talking about this client, I would say "we" rather than "they".

1 2 3 4 5

Not at all Very

Strongly disagree — Strongly agree

b) This client's successes would be my successes.

1 2 3 4 5

Not at all Very

Strongly disagree — Strongly agree

c) When someone praised this client, it would feel like a personal compliment.

1 2 3 4 5

Not at all Very

Strongly disagree — Strongly agree

d) When someone criticized this client, it would feel like a personal insult.

1 2 3 4 5

Not at all Very

Strongly disagree — Strongly agree

e) If a taxing authority questioned this client, it would feel like a personal insult.

1 2 3 4 5

Not at all Very

Strongly disagree — Strongly agree

11) Please circle the number, on each scale, that **best reflects** your beliefs.

a) In an instance where no judicial authority exists with respect to an issue and where the Code and Regulations are ambiguous, I feel that John and Joanne are entitled to take the most favorable tax treatment.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

b) Generally speaking, my loyalties are first to the tax system, then to John and Joanne.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

c) I feel I should apply ambiguous tax law to John and Joanne's benefit.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

d) When examining a tax return, I tend to point out to John and Joanne reasonable positions they could have taken which would have contributed to minimizing their tax liability.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

e) I believe it is important that I encourage John and Joanne to pay the least amount of taxes possible.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

f) I always interpret unclear/ambiguous laws in favor of John and Joanne.

1 2 3 4 5 6 7

Strongly disagree Strongly agree

g) It is important to use trends in the law by trying to establish a pattern of more favorable treatment for John and Joanne and then extending this pattern to the taxpayer's position.

1 2 3 4 5 6 7
Strongly disagree Strongly agree

h) Where no judicial authority exists with respect to an issue, I feel that John and Joanne are entitled to take the most favorable tax treatment.

1 2 3 4 5 6 7
Strongly disagree Strongly agree

i) John and Joanne have the right to structure transactions in ways that yield the best tax result, even if the law is unclear in an area.

1 2 3 4 5 6 7
Strongly disagree Strongly agree

12) Please answer the following questions about the **CPA profession** by circling the number on each scale that represents your response:

a) When someone criticizes my *profession*, it feels like a personal insult.

1 2 3 4 5
Not at all Very
Strongly disagree Strongly agree

b) When I talk about my *profession*, I usually say "we" rather than "they".

1 2 3 4 5
Not at all Very
Strongly disagree Strongly agree

c) I am very interested in what others think about my *profession*.

1 2 3 4 5
Not at all Very
Strongly disagree Strongly agree

d) My *profession*'s successes are my successes.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

e) When someone praises my *profession*, it feels like a personal compliment.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

13) Please answer the following questions about your **firm** by circling the number on each scale that represents your response:

a) When I talk about *my firm*, I usually say "we" rather than "they".

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

b) *My firm's* successes are my successes.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

c) I am very interested in what others think about *my firm*.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

d) When someone criticizes *my firm*, it feels like a personal insult.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

e) When someone praises *my firm*, it feels like a personal compliment.

1 2 3 4 5
|Not at all | | | Very
Strongly disagree Strongly agree

14) Do you feel that you are likely to make a different tax recommendation to a client you know and like versus a client that you don't know or don't like?

Yes No

15) Would you be likely to make the same decision, a more aggressive decision, or a less aggressive decision for a client you know and like versus a client that you don't know or don't like?

1	2	3	4	5	6	7
Less Aggressive Decision			Same Decision			More Aggressive Decision

16) Would you be likely to make the same decision, a more aggressive decision, or a less aggressive decision for a client when facing higher IRS scrutiny?

1	2	3	4	5	6	7
Less Aggressive Decision			Same Decision			More Aggressive Decision

17) Would you be likely to make the same decision, a more aggressive decision, or a less aggressive decision for a client you consider to be "low risk" versus a client you consider to be "high risk"?

1	2	3	4	5	6	7
Less Aggressive Decision			Same Decision			More Aggressive Decision

18) Which of the following best describes how you conduct research to reach a tax recommendation for a client? (Circle one answer.)

a) Verify basic support for the most client favorable tax position and research the finer details later if the tax position is ever questioned

b) Use as much time as needed to research the tax issue, examining the pros and cons of each potential tax position for the client

c) Determine the amount of time that I can allot to the research and then conduct research that first supports the preferred tax position and, if there's time, research the pros and cons of each tax position for the client

d) Think about the tax position that best benefits the client and conduct research to support that position

19) If you are given a limited amount of time to research a potential tax position for a client, how would you conduct your research efforts? Please circle the number that *best reflects* your research strategy

1 2 3 4 5

Not at all Very

Conduct research to support most favorable client position, given time constraints

Conduct research to examine the pros and cons of each potential tax position, regardless of time constraints

Please answer the following demographic questions. Your answers are important.

1) Please indicate if you are a CPA. Yes No

2) Please indicate the number of months of professional public accounting experience you have ***as a tax professional/preparer***. ____________*months*

3) How would you best characterize the type of firm you work in? Please circle one choice.

Big 4 International National Regional Local Industry

4) Please indicate the number of months you have been employed with your current firm. __________________*months*

5) Please circle your highest level of education completed: Bachelor Master/MBA JD/PHD

6) Please circle your current age bracket.

Under 30 31-35 36-40 41-45 46-50 51-55 56-60 61-65 66-70 Over 70

7) Please circle your gender. Female Male

You have successfully completed the experiment! Thank you!!

Please bring your completed materials to the front of the room where you will receive your raffle ticket. We will conduct the raffle shortly!

Appendix A – Business/Hobby Decision

Treasury Regulation §1.183-2 excerpts:

Sec. 1.183-2

(b) *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* The term profit encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183–1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

Post-Experimental Questionnaire

Please answer the following questions once you have completed the previous materials. Please do not go back and change your answers above.

For questions 1-4: Please circle the number, on each scale, that **best reflects** your beliefs.

1) How important was the following in your recommendation decision for the case study you just completed: Your risk of economic loss from penalties and litigation?

1 2 3 4 5 6 7

Not Important — Extremely Important

2) How important was the following in your recommendation decision for the case study you just completed: Your risk of loss of your professional reputation?

1 2 3 4 5 6 7

Not Important — Extremely Important

3) How important was the following in your recommendation decision for the case study you just completed: Maintaining the client relationship?

1 2 3 4 5 6 7

Not Important — Extremely Important

4) What is your assessed likelihood that *business treatment* of the tax issue (in the case study you just completed) would be sustained on its merits?

|------------------|------------------|------------------|------------------|------------------|

0% 20% 40% 60% 80% 100%

Not likely at all to be sustained — Extremely likely to be sustained

5) Do you currently have the authority to recommend tax positions to tax clients? (Please circle yes or no.)

Yes No

6) In current tax practice, what is the tax return preparer penalty currently in place under IRC Section 6694 for unreasonable (undisclosed) positions that result in underpayment of the tax liability? Please circle the best answer.

a) $250

b) $500

c) The greater of $1000 or 50 percent of the income derived by the tax return preparer

7) In current tax practice, what is the tax return preparer standard currently in place under IRC Section 6694 for unreasonable (undisclosed) positions that result in underpayment of the tax liability? Please circle the best answer.

a) Realistic Possibility Standard (i.e., a 1 in 3 chance or better that the tax position will be sustained on its merits)

b) Substantial Authority Standard (i.e., approximately 40 percent chance or better that the tax position will be sustained on its merits)

c) More Likely Than Not Standard (i.e., a greater than 50 percent chance that the tax position will be sustained on its merits)

VITA
BETH Y. VERMEER

Education

Ph.D.	Accounting Drexel University, Philadelphia, PA Dissertation Final Defense – Passed May 17, 2013	June 2013
M.S.	Accounting/Taxation University of North Texas, Denton, TX	May 1996
B.S.	Accounting University of North Texas, Denton, TX	May 1996

Awards and Honors

AICPA Accounting Doctoral Scholar (ADS Program) 2010 to present

Professional Certification

Certified Public Accountant (Maryland - currently inactive) February 1997

Papers Under Review

Vermeer, B., Curatola, A., and Reichert, B. (2012) “IRS Oversight, Client Risk, and Tax Professionals: Does Increased Control Deter Aggressive Decision Making?”, revise and resubmit at *Journal of the American Taxation Association*

Vermeer, B., and Curatola, A. (2013) “Tax Professionals and Antecedents to Aggressive Decision Making: An Examination of Client Identification and Economic Importance”, under review at *Contemporary Accounting Research*

Vermeer, B., and Greenstein, B. (2013) “The Foreign Tax Credit and Substance Over Form: A Case of the United Kingdom Windfall Tax”, under review at *Journal of Legal Tax Research* (American Accounting Association Sectional Journal)

Working Papers

Vermeer, B. (2012) “Behavioral Tax Research and Tax Professionals: A Review and Prospective”, targeted for publication in *Journal of Accounting Literature*

Vermeer, B. (2012) “Audit Quality and Auditor Identification: An Experimental Study of Big Four and Non-Big Four Auditors”

Teaching Experience

Drexel University Philadelphia, Pennsylvania
PhD Candidate/Instructor Fall 2012 - June 2013

Taught financial accounting principles courses. Overall instructor evaluation: 3.82/4.00 where 1 is strongly disagree and 4 is strongly agree.

Howard Community College Columbia, Maryland
Assistant Professor August 2006-July 2007

Taught financial and managerial accounting principles courses. Assisted with coordination and oversight of adjunct faculty, accounting curriculum development, and CPA preparation programs. Worked with AICPA On-Campus Champion program and MACPA Outreach Programs. Overall ratings for excellent teacher: 4.82/5.0 where 5 is excellent and 1 is poor.

University of Baltimore Baltimore, Maryland
Adjunct Professor January 2005-December 2005

Taught Intermediate Accounting courses at both undergraduate and graduate levels. Overall cumulative instructor evaluations: graduate 4.92/5.0 and undergraduate 4.90/5.0 where 5 is outstanding and 1 is poor.

Prince George's Community College Largo, Maryland
Full Professor August 1999-December 2005

Taught financial and managerial accounting principles courses, federal income taxation courses, and advanced taxation courses. Developed online courses in federal income tax and advanced tax. Coordinated Volunteer Income Tax Assistance (VITA) program on campus. Worked with Junior Achievement, AICPA On-Campus Champion Program, and MACPA outreach programs. Overall cumulative instructor evaluations: 4.72/5.00 where 5 is excellent (strongly agree) and 1 is poor (strongly disagree).

Professional Experience

Beth Y. Vermeer, CPA Clarksville, Maryland
Self-employed accountant and tax advisor

Cohen, Rutherford & Knight, PC Bethesda, MD
Assistant Vice President, Tax Services

Grace, Reed & Kreider, P.C. Hershey, Pennsylvania
Tax and Financial Planning Advisor

Arthur Andersen LLP Dallas, Texas
Tax and Business Advisor